POLICE AND CRIME COMMISSIONER FOR HAMPSHIRE AND HAMPSHIRE CONSTABULARY

JOINT AUDIT COMMITTEE – 24 SEPTEMBER 2013

ANNUAL TREASURY MID-YEAR REPORT 2013/14

REPORT OF THE CHIEF FINANCE OFFICER OF THE POLICE AND CRIME COMMISSIONER

1 PURPOSE

1.1 The Treasury Management Strategy for 2013/14 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2 The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that the OPCC is embracing best practice in accordance with CIPFA's recommendations.

1.3 Treasury management is defined as: "The management of investments and cash flows, banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2 RECOMMENDATION

This report recommends that:

2.1 The Joint Audit Committee notes the treasury management mid-year report for 2013/14.

3 ECONOMIC BACKGROUND

3.1 The following paragraphs outline major macro economic themes in the domestic and global economy, which explain the background against which treasury management decisions have been made.

3.2 Growth - the UK economy showed some improvement, with consumer spending boosting growth. Gross Domestic Product (GDP) for the first quarter of 2013 was +0.3% and for the second quarter was +0.7%. Recent data suggests a similar rate in quarter three. Some positive signs for household spending emerged. The deterioration in real earnings growth (i.e. earnings less inflation) slowed, which implied a slower erosion of purchasing power. Consumer confidence improved.

Household savings rates remained high, which is unsurprising given the uncertain economic outlook, but appear to be on a downward track, suggesting spending was being driven by borrowing or lower savings. This raises questions about the sustainability of the recovery at these rates of growth.

3.3 Inflation - annual CPI for July (published in August) was 2.8%. Inflation rose in line with expectations and is expected to remain close to this level throughout the autumn. Further out, inflation should fall back towards the 2% target as external price pressures fade and a revival in productivity growth curbs domestic cost pressures.

3.4 Monetary Policy - there was no change to UK monetary policy with official interest rates and asset purchases maintained at 0.5% and £375bn respectively. The main development for UK monetary policy was the start of Mark Carney’s tenure as Governor of the Bank of England and the implementation of forward guidance. Within the August Inflation Report, the Bank stated its forward guidance, the main element of which is to defer monetary tightening (an increase in interest rates) until the International Labour Organisation (ILO) Unemployment Rate falls below 7% (among a raft of caveats). The Bank projected that the probability of this happening would remain below 50% until 2016.

3.5 Global Economy - whilst the outlook for the global economy appeared to have improved over the first half of 2013/14, significant economic risks remain, particularly in China and the Eurozone. The Chinese banking system is facing tighter liquidity conditions as officials seek to slow down rampant credit growth, and, despite the time gained by the European Central Bank to allow individual members and the Eurozone as a whole to reform their economies, the Eurozone debt crisis has not gone away. The region appears to be dragging itself out of recession, but up-coming political events, such as the German general election, could derail any progress towards a more balanced and stable regional economy.

3.6 The US recovery appears to be in train, but political risks remain regarding the debt ceiling and the federal budget. In his testimony to Congress on 22nd May the US Federal Reserve (Fed) Chairman Ben Bernanke stated that, if the nascent recovery in the US economy became established, the Fed would reduce its $85bn monthly asset purchase programme – Quantitative Easing (QE). The apparent movement by the Fed towards tapering its open-ended QE programme prompted extreme asset price volatility in bonds and equities, as investors sought to crystallise gains driven by excessive liquidity. As a consequence, government bond yields spiked.

4 INVESTMENTS

4.1 The OPCC has an investment portfolio consisting of reserves and short-term cash flows. The OPCC is currently investing according to a low risk, high quality lending list as outlined in its Treasury

Management Strategy. In compliance with this Strategy, lending is restricted to UK clearing banks, the largest UK building society, AAA-rated money market funds, other local authorities and the Government's Debt Management Office

4.2 The OPCC's investment holding was £83.3m at 31 August 2013, which was placed with the following counterparties:

Counterparty	£m	£m
Barclays	11.0	
Close Brothers	10.0	
HSBC	7.0	
Lloyds TSB	12.0	
Nationwide	12.0	
NatWest	11.3	
Banks and Building Societies sub-total (less than 1 year)		63.3
UK Local authorities (less than 1 year)		18.0
UK Local authorities (from 1 to 3 years)		2.0
Total		83.3

4.3 The level of cash balances is expected to fall significantly between now and the end of the financial year when they are forecast to be around £26m. The major reason for the uneven profile of the OPCC's cash balance is the Police Pension Grant of £42m, which is paid by Central Government in a single instalment each July, and then paid out gradually by the OPCC throughout the year.

4.4 The average interest rate earned on these investments at 31 August 2013 was 0.83%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money market rates.

4.5 The Guidance on Local Government Investments in England gives priority to security and liquidity and the OPCC's aim is to achieve a yield commensurate with these principles. This has been maintained by following the OPCC's counterparty policy as set out in its Treasury Management Strategy for 2013/14.

4.6 Counterparty credit quality is assessed and monitored with reference to a range of factors, including but not limited to, the ratings of the major ratings agencies. During the five months to the end of August 2013 investment counterparties and the duration of new investments have been monitored and amended where necessary based on this assessment. For example based on the assessment that a 'good bank' and 'bad bank' split for RBS was being favoured by the Chancellor as a potential plan for the government to sell its stake in RBS, the credit ratings agency Moody's placed RBS's rating on review for downgrade on 5 July 2013. Although the probability of losses remains low as a precautionary measure the OPCC has reduced its maximum duration on RBS (including NatWest) investments to overnight.

5 BORROWING

5.1 The OPCC's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2013 was £48.4m. Affordability and the "cost of carry" remained important influences on the OPCC's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

5.2 For the OPCC the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place in the five months to August 2013, or is planned for the remainder of the financial year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

5.3 As at 31 August 2013 the OPCC had a total of £37.7m of long term loans, made up of a number of Public Works Loan Board (PWLB) loans at a weighted average fixed interest rate of 3.98%, and average outstanding term remaining of 17.8 years. This average rate is slightly below the rate currently being offered for a similar timescale and therefore when viewed against historic interest rates the debt portfolio represents good mitigation against the long-term risk of exposure to interest rate fluctuations, which could increase the cost of borrowing.

5.4 The recent increase in Gilt rates has driven up the rates for new PWLB loans and lowered the premium that would apply on the premature redemption of loans, but the premia is still relatively expensive for the loans in the OPCC's portfolio and therefore unattractive for debt rescheduling. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for the OPCC to reduce or restructure its debt portfolio.

6 COMPLIANCE WITH PRUDENTIAL INDICATORS

6.1 During the first five months of 2013/14, the OPCC operated within the treasury management indicators set out in the Treasury Management Strategy.

Authorised limit for external debt

6.2 CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by the Police and Crime Commissioner on 11 February 2013 set an authorised limit for external debt of £80m.

6.3 This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the OPCC's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.

6.4 During the five month period to 31 August 2013 borrowing remained well within the authorised limit of £80m and no new long term borrowing has been taken out. Total external debt peaked in May at £41.4m when for cash flow requirements the OPCC borrowed £2m from Cambridge City Council for one week (at a rate of 0.33%). This was an exceptional, one-off occurrence, when the available cash was lower than the level that had been allowed for liquidity purposes. In normal circumstances investments are planned to ensure that there is the liquidity available to meet cash requirements to avoid the need for short term borrowing.

Operational boundary for external debt

6.5 The OPCC has set an operational boundary for external debt. This should reflect the most likely scenario and be consistent with the OPCC's capital plans and Treasury Management Strategy. Temporary breaches of the 2013/14 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The PCC approved an operational boundary for 2013/14 of £70m.

6.6 As outlined above the OPCC's maximum total external debt of £41.4m in the period from April to August 2013, was within the operational boundary.

Upper limit on fixed and variable interest rate exposure

6.7 The OPCC has to set an upper limit on its fixed interest rate exposure for both total investments and total external debt. The PCC approved an upper limit on fixed interest rate exposure for external debt for 2013/14 of £70m, which is based on the operational boundary and has been set to give the OPCC maximum policy flexibility. The limit enables the potential for refinancing e.g. from variable to fixed rate borrowing. All of the OPCC's long-term debt portfolio, which is made up of fixed interest loans, was its maximum in the 5 month period to 31 August 2013 at £38.4m and therefore within the £70m limit. The £2m of one-off temporary borrowing outlined above is counted as variable rate borrowing and therefore is also within the limit.

6.8 The OPCC also has to set an upper limit on its interest rate exposure for fixed and variable rate investments, which is £95m and £80m respectively. In the period from April to August 2013 the OPCC had a maximum of £41m of investments at fixed rates and £61.3m at variable rates, both within the approved limits above.

Upper and lower percentage limits on the maturity structure of long-term fixed-rate borrowing outstanding in 2013/14

6.9 The Code also requires the OPCC to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2013/14. The following table shows the limits approved by the OPCC. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

	Upper limit (%)	**Lower limit (%)**	**Actual (%)**
Under 12 months	50	0	3
12 to 24 months	50	0	3
24 months to 5 years	50	0	11
5 years to 10 years	75	0	5
10 years and within 20 years	75	0	22
20 years and within 30 years	100	0	56
30 years and above	100	0	0

Upper limits on investments with maturities longer than one year

6.10 For 2013/14 the OPCC restricted investments for periods up to a maximum of three years to UK local authorities, with an upper limit of £20m and the maximum investment being placed with a single institution restricted to £5m.

6.11 At 31 August 2013 the OPCC had £2m of investments over 364 days up to a maximum of three years with other UK local authorities, with a further £5m of investments agreed with local authority counterparties but due to begin in the next month.

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APPENDICIES: None