POLICE AND CRIME COMMISSIONER FOR HAMPSHIRE AND HAMPSHIRE CONSTABULARY

JOINT AUDIT COMMITTEE – 15 SEPTEMBER 2016

Treasury Management Mid-Year Report 2016/17

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

1. Purpose

1.1. The Treasury Management Strategy for 2016/17 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 Office of the Police and Crime Commissioner (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 transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent whit those risks'.

2. Recommendation

2.1. It is recommended that the Joint Audit Committee considers the report and makes observations as appropriate, prior to it being reported to the PCC.

3. Economic Background

3.1. The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

3.2. The preliminary estimate of Q2 2016 GDP showed strong growth as the economy grew 0.6% quarter-on-quarter, as compared to 0.4% in Q1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23 June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of these downside risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

3.3. The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee (MPC) to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Base Rate to 0.25%, further gilt and corporate bond purchases (quantitative easing (QE)) and cheap funding for banks to maintain the supply of credit to the economy. MPC members also played on expectations, suggesting that many members of the MPC supported a further cut in Bank Base Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic decline worsen.

3.4. In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Banks are being heavily encouraged to pass on the reduction in rates to customers – great for borrowers, although the outlook for savers is now rather more downbeat. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'. Arlingclose's central forecast case for Bank Base Rate is currently 0.25%, but there is a strong possibility that the rate is cut further towards zero.

3.5. Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening wage growth and real investment returns. The August Quarterly Inflation Report from the Bank of England correctly forecast a rise in CPI to 0.6%, and has forecast that it will increase to 0.8% and will end 2016 at 0.9%. As outlined in the Report and by Governor Mark Carney this will be driven by the pace of transmission into prices of the higher cost of imports arising from the post-Brexit vote depreciation in sterling implying that there is scope for the rise in inflation to be less linear than the Bank's forecasts suggest.

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.

4.2. The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors (including Police and Crime Commissioners) through potential bail-in of unsecured bank deposits. (The outcome of the EU referendum does not alter the UK's legislated bail-in resolution regime).

4.3. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the OPCC's aim to further diversify into more secure and/or higher yielding asset classes. The majority of the OPCC's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds.

4.4. The OPCC's investment holding was £103.03m at 18 August 2016, which is £12.9m (11.1%) lower than the same time last year, and was placed in the following investment types:

Table 1 – Investments as at 18 August 2016

Duration to maturity	Overnight £m	<1 year £m	>1 year £m	Total £m	Average Rate/Yield %	Average Life years
Subject to bail-in risk						
Bank call accounts	3.05	-	-	3.05	0.40%	0.00
Bank notice accounts	-	12.00	-	12.00	1.03%	0.30
Bank certificates of deposit[1]	-	10.00	-	10.00	0.53%	0.43
	3.05	22.00	-	25.05	0.70%	0.32
Exempt from bail-in risk						
Covered floating rate notes	-	6.50	14.00	20.50	0.79%	1.38
Covered fixed bonds	-	2.45	1.00	3.45	1.05%	0.64
Supranational bonds	-	1.00	-	1.00	0.61%	0.30
Government bonds	-	2.00	-	2.00	0.71%	0.32
Money market funds	30.77	-	-	30.77	0.41%	0.00
Local authorities	-	11.6	5.00	16.60	1.10%	0.81
Pooled equity funds[2]			0.66	0.66	-	-
Pooled property fund	-	-	3.00	3.00	5.12%	-
	30.77	23.55	23.66	77.98	0.88%	0.63
Total	33.82	45.55	23.66	103.03	0.84%	0.56

[1] Certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.
[2] The pooled equity funds income return is not included within the total average rate/yield as at 18 August 2016 as these are new investments, and the income returns are not yet available.

4.5. Security of capital has remained the OPCC's main investment objective. This has been maintained by following the OPCC's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17.

4.6. Counterparty credit quality was assessed and monitored with reference to credit ratings (the OPCC's minimum long-term counterparty rating for institutions defined as having "high credit quality" is BBB across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.7. The level of cash balances is expected to fall between now and the end of the financial year when they are forecast to be around £46m. The major reason for the uneven profile of the OPCC's cash balance is the Police Pension Grant of £46m, which is paid by Central Government in a single instalment each July, and then paid out gradually by the OPCC throughout the year.

4.8. The average interest rate earned on these investments at 18 August 2016 was 0.84%, which should be considered within the context of a recently lowered UK Base Rate of 0.25%, following a period of over 7 years of unchanged UK Base Rate at 0.5%, and very low short-term money market rates. This rate reflects interest rates available prior to the base rate cut, and is likely to fall in the coming months.

4.9. 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 2016/17.

5. Borrowing

5.1. The OPCC's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2016 was £51.4m. 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 to date in 2016/17, or is planned for the remainder of the year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

5.3. As at 18/08//2016 the OPCC held £33.6m of loans, made up of Public Works Loan Board (PWLB) loans, (a decrease of £0.6m on 31/3/2016), as part of its strategy for funding previous years' capital programmes.

5.4. The premia that applies to the premature repayment of the OPCC's PWLB loans is still relatively expensive for the loans in the 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 period to date of 2016/17, the OPCC operated within the Prudential Indicators for 2016/17, which were set in March 2016 as part of the OPCC's Treasury Management Strategy Statement.

Authorised Limit and Operational Boundary 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 March 2016 set an authorised limit for external debt of £78m.

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. The OPCC has set an operational boundary for external debt reflecting the more likely scenario and consistent with the OPCC's capital plans and Treasury Management Strategy. Temporary breaches of 2016/17 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 2016/17 of £65m.

	Authorised Limit £m	**Operational Boundary £m**	**2016/17 Actual £m**
Borrowing	73.0	60.0	33.6
Other long-term liabilities	5.0	5.0	0.0
Total Debt	**78.0**	**65.0**	**33.6**

6.5. During the period to 18 August 2016 borrowing remained well within the authorised limit and operational boundary, and no new long term borrowing has been taken out. There has been no temporary borrowing, so the maximum total external debt in the period has remained at the total long-term borrowing amount, which is now £33.6m.

7. Treasury Management Indicators

7.1. The OPCC measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

7.2. The OPCC has to set an upper limit on its fixed and variable interest rate exposure for both total investments and total external debt. This indicator is set to control the OPCC's exposure to interest rate risk. The PCC approved the following upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed or invested. None of the limits have been exceeded.

	2016/17 Limit	Maximum to 18 August 2016
Upper limit on fixed interest rate investment exposure	£33m	£10.0m
Upper limit on variable interest rate investment exposure	£130m	£106.5m
Upper limit on fixed interest rate borrowing exposure	£85m	£34.2m
Upper limit on variable interest rate borrowing exposure	£85m	£0.0m

7.3. The limit for borrowing rate exposures has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. All of the OPCC's long-term debt portfolio is currently made up of fixed interest loans.

7.4. The upper limit for exposure for investments rates is based on an extreme case of the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less than one year) if necessary.

Maturity Structure of Borrowing

7.5. 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 2016/17. The following table shows the limits approved by the PCC. These have been set to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

	Upper	Lower	Actual
Under 12 months	50%	0%	0%
12 months and within 24 months	50%	0%	4.25%
24 months and within 5 years	50%	0%	7.43%
5 years and within 10 years	75%	0%	2.08%
10 years and within 20 years	75%	0%	68.40%
20 years and above	100%	0%	17.84%

Principal Sums Invested for Periods Longer than 364 days

7.6. The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. For 2016/17 the OPCC restricted investments for periods of over a year to a maximum of £33m. At 18 August 2016 the OPCC had £23.66m of investments with over 364 days to their maturity.