POLICE & CRIME COMMISSIONER

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POLICE AND CRIME COMMISSIONER FOR HAMPSHIRE AND HAMPSHIRE CONSTABULARY

JOINT AUDIT COMMITTEE – 26 July 2018 **ITEM 13**

Annual Treasury Outturn Report 2017/18

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

1. Purpose

1.1. The Office of the Police & Crime Commissioner for Hampshire (OPCC) adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on treasury management activity after the end of each financial year.

2. Recommendation

2.1. It is recommended that the Joint Audit Committee considers the report and makes observations as appropriate.

3. Introduction

3.1. This report fulfils the OPCC's legal obligation to have regard to the CIPFA Code.

3.2. The OPCC's treasury management strategy for 2017/18 was approved by the Police and Crime Commissioner (PCC) for Hampshire in March 2017. The OPCC has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the OPCC's treasury management strategy.

3.3. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its 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."

3.4. This annual report sets out the performance of the treasury management function during 2017/18, to include the effects of the decisions taken and the transactions executed in the past year.

3.5. Overall responsibility for treasury management remains with the OPCC. No treasury management activity is without risk; the effective identification and management of risk are integral to the OPCC's treasury management objectives.

3.6. All treasury activity has complied with the OPCC's Treasury Management Strategy and Investment Strategy for 2017/18, and all relevant statute, guidance and accounting standards. In addition the OPCC's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. The OPCC has also complied with all of the prudential indicators set in its Treasury Management Strategy.

4. External Context

4.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2017/18.

Economic Background

4.2. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

4.3. The inflationary impact of rising import prices, a consequence of the fall in Sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.2% in March 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June 2017 and by the lack of clarity on Brexit. The Withdrawal Treaty is yet to be ratified by the UK Parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

4.4. The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. This action was significant as this was the first rate increase in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February Inflation Report indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March and May 2018 two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates. At the meeting in

June 2018 the MPC voted by a majority of 6-3 to maintain Bank Rate at 0.5% - this change has been taken by the market as a signal of an August 2018 rate rise.

Credit Background

4.5. The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the OPCC would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

4.6. Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

4.7. In March 2018, following Arlingclose's advice, the OPCC removed RBS plc and National Westminster Bank from its counterparty list for unsecured investments. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for 2018/19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the OPCC's unsecured lending list.

Regulatory Changes

4.8. CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. The Code also expands on the process and governance issues of capital expenditure and investment decisions. The OPCC will be preparing the Capital Strategy in line with the 2019/20 budget setting process.

4.9. In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

MiFID II

4.10. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities (including police and crime commissioners) were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least one year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

4.11. The OPCC has met the conditions to opt up to professional status and has done so in order to maintain its previous MiFID status prior to January 2018. The OPCC will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

5. Local Context

5.1. At 31 March 2018 the OPCC's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £50.1m, while usable reserves and working capital which are the underlying resources available for investment were £55.0m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on-year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m
CFR	(42.4)	(7.7)	(50.1)
Less: Resources for investment	73.0	(18.0)	55.0
Net investments	30.6	(25.7)	4.9

5.2. CFR has risen as new capital expenditure was higher in comparison to the amount of debt repaid in 2017/18, resulting in net investments reducing overall due to a significant reduction in resource for investment. A number of capital receipts which were anticipated to be received during the year have slipped back to later years, and therefore resources for investment have reduced due to an increased draw to internally funded capital in lieu of the anticipated receipts.

5.3. In addition resources for investments have reduced due to an increased draw from balances to fund transformation activity mainly in Hampshire Constabulary.

5.4. The OPCC's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2018 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %
Long-term borrowing	(31.8)	0.8	(31.0)	4.23
Short-term borrowing	(1.2)	0.4	(0.8)	2.46
Total borrowing	(33.0)	1.2	(31.8)	4.18
Long-term investments	24.0	(1.5)	22.5	1.68
Short-term investments	34.0	(3.0)	31.0	0.67
Cash and cash equivalents	14.5	(13.5)	1.0	0.40
Total investments	72.5	(18.0)	54.5	1.08
Net investments	39.5	(16.8)	22.7	

Note: the figures in the table above are from the balance sheet in the OPCC's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

5.5. The OPCC's internal borrowing policy is the reason for the variance between the positions shown in Tables 1 and 2. The movement that has taken place during 2017/18 in net investments shown in Table 1 has translated in a reduction in investment balances as shown in Table 2. In addition, total borrowing in Table 2 has reduced during 2017/18 due to the repayment upon maturity of £1.2m of Public Works Loan Board (PWLB) debt.

6. Borrowing Activity

6.1. At 31 March 2018 the OPCC held £31.8m of loans, a decrease of £1.2m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 overleaf.

Table 3: Borrowing Position

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Public Works Loan Board	33.0	(1.2)	31.8	4.18	15.51
Total borrowing	33.0	(1.2)	31.8	4.18	15.51

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the OPCC's statement of accounts, but adjusted to exclude accrued interest.

6.2. The OPCC's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the OPCC's long-term plans change being a secondary objective.

6.3. 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. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the OPCC determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing. This strategy enabled the OPCC to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

6.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the OPCC with the monitoring of internal and external borrowing.

6.5. During 2017/18 the OPCC repaid £1.2m of maturing PWLB debt, and did not replace this borrowing. This will reduce the future cost of interest payments on the OPCC's external debt.

7. Investment Activity

7.1. The OPCC holds invested funds representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the OPCC's investment balances have ranged between £54.5 and £122.6 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Short term investments					
- Banks and Building Societies					
- Unsecured	14.6	(8.6)	6.0	0.58	0.15
- Secured	4.0	5.5	9.5	0.89	0.64
- Money Market Funds	12.4	(12.4)	-	-	-
- Local Authorities	16.5	-	16.5	0.55	0.25
- Corporate Bonds	1.0	(1.0)	-	-	-
	48.5	(16.5)	32.0	0.66	0.35
Long term investments					
- Banks and Building Societies					
- Secured	17.0	(5.5)	11.5	0.78	1.49
- Local Authorities	2.0	4.0	6.0	0.61	0.87
	19.0	(1.5)	17.5	0.72	1.28
High yield investments					
- Pooled Property Funds	3.0	-	3.0	4.54	n/a
- Pooled Equity Funds	2.0	-	2.0	5.86	n/a
	5.0	-	5.0	5.07	n/a
TOTAL INVESTMENTS	72.5	(18.0)	54.5	1.08	0.68

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2018.

Note: the figures in the table above are from the balance sheet in the OPCC's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

7.2. Both the CIPFA Code and the government guidance require the OPCC to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The OPCC's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

7.3. In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the OPCC further diversified into more secure and higher yielding asset classes during 2017/18. For example, the allocation to unsecured bank investments and money market funds reduced from 37% to 11%, whilst secured bank investments increased from 30% to 39%. In addition overall cash balances have reduced, whilst the allocation in monetary terms to high yield investments has remained the same, resulting in a proportional increase from 7% to 9%.

7.4. 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 2017/18.

7.5. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

7.6. The OPCC will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

7.7. The OPCC maintained a sufficient level of liquidity through the use of call accounts and money market funds. The OPCC sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate increased by 0.25% to 0.50% in November 2017 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

7.8. The progression of credit risk and return metrics for the OPCC's investments management in-house (i.e. excluding pooled funds) are shown in the extracts from Arlingclose's investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	AA+	40%	231	0.63%
31.03.2018	AA+	12%	247	0.68%
Police & Fire Authorities	AA-	55%	90	0.50%
All LAs	AA-	55%	35	063%

* Weighted average maturity

7.9. The OPCC has targeted a proportion of its funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the OPCC, although some come with the risk that they may suffer falls in the value of the principal invested.

7.10. The £5m portfolio of externally managed pooled equity and property funds generated an average total return of 6.4%, comprising 5.0% income return used to support services in year, and 1.3% of capital growth. As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the OPCC's investment objectives are regularly reviewed.

7.11. The investments in pooled funds allow the OPCC to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the OPCC's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.

7.12. Although money can be redeemed from the pooled funds at short notice, the OPCC's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the OPCC's investment objectives are monitored regularly and discussed with Arlingclose.

8. Financial Implications

8.1. The outturn for debt interest paid in 2017/18 was £1.3m on an average debt portfolio of £32.4m.

8.2. The outturn for investment income received in 2017/18 was £647,000, (against a budget of £500,000) on an average investment portfolio of £85.5m, therefore giving an average yield for the year of 0.76%.

9. Other Non-Treasury Holdings and Activity

9.1. Although not classed as treasury management activities the OPCC may also make loans and investments for service purposes, for example the direct purchase of land or property. Such loans and investments will be subject to the OPCC's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The OPCC does not have any existing non-treasury investments.

10. Compliance Report

10.1. The OPCC confirms compliance of all treasury management activities undertaken during 2017/18 with the CIPFA Code of Practice and the approved Treasury Management Strategy. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 and 7 overleaf.

Table 6: Debt Limits

	2017/18 Maximum £m	31/03/18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	34	33	57	70	✓
Other long term liabilities	0	0	5	5	✓
Total debt	34	33	62	75	✓

Table 7: Investment limits

	2017/18 Maximum	31/03/18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£9m	£5m	£12m	✓
Any group of organisations under the same ownership	£9m	£5m	£12m	✓
Any group of pooled funds under the same management	£5m	£3m	£12m	✓
Registered providers	£0m	£0m	£12m	✓
Money market funds	21%	0%	50%	✓

11. Treasury Management Indicators

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

Interest Rate Exposures

11.2. This indicator is set to control the OPCC's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 8: Interest Rate Exposures

	31/03/18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate investment exposure	£4m	£25m	✓
Upper limit on variable interest rate investment exposure	£51m	£130m	✓
Upper limit on fixed interest rate borrowing exposure	£31m	£86m	✓
Upper limit on variable interest rate borrowing exposure	£1m	£86m	✓

11.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

11.4. This indicator is set to control the OPCC's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 9: Maturity Structure of Borrowing

	31/03/18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	50%	0%	✓
12 months and within 24 months	2%	50%	0%	✓
24 months and within 5 years	2%	50%	0%	✓
5 years and within 10 years	2%	75%	0%	✓
10 years and within 20 years	85%	100%	0%	✓
20 years and above	6%	100%	0%	✓

Principal Sums Invested for Periods Longer than 364 days

11.5. The purpose of this indicator is to control the OPCC's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 10: Principal Sums Invested for Periods Longer than 364 days

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£19m	£10m	£5m
Limit on principal invested beyond year end	£25m	£25m	£25m
Complied	✓	✓	✓