OFFICE OF THE POLICE AND CRIME COMMISSIONER
FOR HUMBERSIDE
DECISION RECORD

Decision Record Number: **05/2017**

Title: **Mid-Year Treasury Management Review Report 2016/17**

Executive Summary:
Report submitted that provided details of the Treasury Management activity undertaken during the period 1 April to 30 September 2016.

Decision:
That the Treasury Management Mid-Year Review Report 2016/17 be approved.

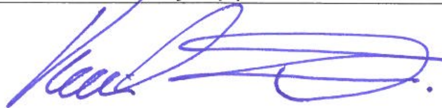
Background Report: Open

Police and Crime Commissioner for Humberside

I confirm I have considered whether or not I have any personal or prejudicial interest in this matter and take the proposed decision in compliance with my code of conduct.

Any such interests are recorded below.

The above decision has my approval.

Signature  **Date 06.03.2017**

Police and Crime Commissioner for Humberside

Treasury Management
Mid-Term Review Report
2016/17

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1 Background

The Police and Crime Commissioner (PCC) operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the PCC's capital plans. These capital plans provide a guide to the borrowing need of the PCC, essentially the longer term cash flow planning to ensure the PCC can meet capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet PCC risk or cost objectives.

Accordingly, treasury management 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."

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by the PCC in March 2016.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the PCC's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the PCC will seek to achieve those policies and objectives.
3. Receipt by the PCC of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the PCC of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the PCC of the role of scrutiny of treasury management strategy and policies to a specific named body. For this PCC the delegated body is the Joint Independent Audit Committee:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2016/17 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The PCC's capital expenditure (prudential indicators);
- A review of the PCC's investment portfolio for 2016/17;
- A review of the PCC's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

3 Economics and interest rates

3.1 Economics update

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme. The referendum vote for Brexit in June 2016 delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys indicated a sharp recovery in confidence.

The Bank of England meeting on August 4th addressed an expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting and suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 would be eased. This was confirmed in the Autumn Statement on 23 November 2016.

The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI started rising during 2016 as the falls in the price of oil and food twelve months earlier fell out of the calculation and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis appeared likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC was expected to look through a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators pointed towards growth in the rest of 2016 picking up. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high and it was suggested that there could four more increases in 2016. However, more downbeat news on the international scene and then the Brexit vote followed causing a delay in the timing of the second increase which took place in December.

In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017. The ECB progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. It also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Japan was still bogged down in anaemic growth and made little progress on fundamental reform of the economy while Chinese economic growth weakened with medium term risks increasing.

3.2 Interest rate forecasts

Capita Asset Services, are the PCC's treasury consultants and part of their service is to assist the PCC to formulate a view on interest rates. The following table gives their central view of future interest rates:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

From the Bank of England's quarterly Inflation Report on 2 February 2017, Capital Asses Services identified a number of key points:-

- An increase in the forecast for GDP growth for 2017 from 1.4% to 2.0% and for 2018 from 1.5% to 1.6%, indicating the UK economy has been, and is likely to be, much more resilient to the effects of Brexit uncertainty than had been previously expected. The Bank quoted the easing of the fiscal squeeze and stronger global economic data in its latest reasoning.
- Little change in inflation forecasts though there were comments around the £ strengthening in value somewhat over the last quarter.
- The equilibrium rate of unemployment was reduced from 5.0% to 4.5%. This potentially means that the MPC could wait longer before taking action to combat rising inflation.
- Some MPC members were clearly more concerned about the degree to which they could look through increases in inflation caused by the effective devaluation of the £ since the referendum and the consequent feed through into the CPI measure of inflation.

The robust forecast for growth for 2017 has raised questions from some commentators as to whether the emergency cut in Bank Rate from 0.50% to 0.25%, and a new programme of quantitative easing (QE), was still warranted i.e. whether they should be reversed. (The UK turned in the strongest GDP growth of any G7 country in 2016 at 2.0% y/y despite the forecast in the August Inflation Report that GDP growth would be nearly zero in the second half of 2016.) Clearly, the MPC decided that such a reversal was not warranted at the current time and there are still some concerns as to whether the potential downside effects of Brexit have only been delayed. Capita's forecasts assume that there is no such cancellation of the emergency cut and a stop to the QE programme in the shorter term. There is a potential risk that the MPC could muster a majority to reverse both before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate.

The House of Commons has concluded the committee stage of considering the White Paper on Article 50 for the UK to leave the EU. This is now in the process of going through the House of Lords.

Capita's overall view is that there is now upside risk to their interest rate forecasts if GDP growth and the rate of growth of inflation, and its peak, are stronger than currently forecast. It is felt that the MPC will focus on inflation risks ahead of protecting growth if inflation looks like rising to levels significantly above current forecasts. However it is very difficult to be at all certain about risks around this, especially when currency movements in the £, $ and Euro will be very hard to predict and are subject to major unknowns.

Another commentator, Capital Economics' forecasts for UK economic growth are as follows: 2017 +1.8%; 2018 +2.5%. They feel that the Bank is still overdoing pessimism and Brexit will not have as big an effect as initially feared by some commentators.

One major uncertainty is the degree to which there will be a major financial stimulus programme in the US - depending on the degree of agreement, or otherwise, between President Trump and Congress. If this stimulus programme is substantial, this is likely to have, in turn, a significant impact on the rise in inflation pressures and the speed of increases in the Fed Funds rate. There are also concerns as to whether the US will enter into a trade and currency value conflict with other major trading nations. The value of the $ against other currencies has been subject to major volatility since the Presidential election and this is likely to continue.

In addition to the issues described above, there are also a significant number of rising EU and geopolitical risks.

Capita Asset Services maintain the view that economic forecasting remains difficult with so many external influences weighing on the UK. Their Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

Capita have pointed out consistently that the Fed. Funds Rate is likely to go up more quickly and more strongly than Bank Rate in the UK and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat during 2016. While there is normally a high degree of correlation between the two yields. It is expected that there will be a growing decoupling of yields i.e. with US yields expected to rise faster than UK yields. This will be closely monitored along with the resulting effect on PWLB rates.

- The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms of Brexit.

- The balance of risks to increases in Bank Rate and shorter maturity PWLB rates are to the upside and dependent on how quickly inflation pressures rise and how high the peak will be.

- Forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU (apart from the departure of the UK), within the forecasting time horizon despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China, which have a major impact on international trade and world GDP growth.

As reported previously, PWLB rates and bond yields are presently very unpredictable with exceptional levels of volatility being experienced that are highly correlated to geo-political and sovereign debt crisis developments.

The forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and combat the potential threat of deflation in western economies.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The pace and timing of increases in the Fed. Funds Rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by the PCC in March 2016 and there are no policy changes in the light of the updated economic position.

Prudential Indicator	***2016/17 Original £m***	***2016/17 Revised £m***
Authorised Limit	70.260	62.660
Operational Boundary	68.260	60.660
Capital Financing Requirement	68.671	61.071

5 The PCC's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The PCC's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	2016/17 Original Estimate £m	2016/17 Current Position £m	2016/17 Revised Estimate £m
Total capital expenditure	13.819	13.819	6.422

A significant underspend is projected on the capital programme. This is because:

- A number of estates schemes planned for 2016/17 have yet to commence and are dependent upon decisions on the final programme.
- Fuel pump infrastructure work of £2m is now unlikely to take place in 2016/17.
- The profile spend on both the Contact Management System Stage 2 and the Connect Criminal Justice System, which are managed through the IS Collaboration service, has changed.

The effect of the above is to reduce the projected spend on the overall capital programme from £13.8m to £6.4m.

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the PCC by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2016/17 Original Estimate £m	2016/17 Current Position £m	2016/17 Revised Estimate £m
Total capital expenditure	**13.819**	**13.819**	**6.422**
Financed by:			
Capital receipts	-	-	1.400
Capital grants	1.078	1.078	0.850
Capital reserves	-	-	-
Revenue	-	-	-
Total financing	**1.078**	**1.078**	**2.250**
Borrowing requirement	**12.741**	**12.741**	**4.172**

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

The original forecast Capital Financing Requirement will move as a result of slippage in the capital programme.

Prudential Indicator – the Operational Boundary for external debt

	2016/17 Original Estimate £m	2016/17 Current Position £m	2016/17 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement			
Total CFR	68.671	68.671	61.071
Net movement in CFR	**9.084**	**9.084**	**1.484**
Prudential Indicator – the Operational Boundary for external debt			
Total borrowing (year end position)	**40.467**	**40.467**	**30.208**

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for capital purposes. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and next two financial years. This allows some flexibility for limited early borrowing for future years. The PCC has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2016/17 Original Estimate £m	2016/17 Current Position £m	2016/17 Revised Estimate £m
Total borrowing	40.467	40.467	30.208
CFR* (year end position)	68.671	68.671	61.071

The Deputy Chief Executive and Treasurer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by the PCC. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2016/17 Original Indicator £m	2016/17 Current Position £m	2016/17 Revised Indicator £m
Total	70.260	70.260	62.660

6 Investment Portfolio

In accordance with the Code, it is the PCC's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the PCC's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

The PCC held £22.90m of investments as at 30 September 2016 (£9.65m at 31 March 2016) and the investment portfolio yield for the first 6 months of the year was 0.52% against a benchmark average 7 day LIBID rate of 0.28 %.

The Deputy Chief Executive and Treasurer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2016/17.

The PCC's budgeted investment return for 2016/17 is £46k, and performance during the first half of the year was £9k above the annual budget.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

7 Borrowing

The PCC's capital financing requirement (CFR) for 2016/17 is £61.071m. The CFR denotes the PCC's underlying need to borrow for capital purposes. If the CFR is positive the PCC may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the PCC has borrowings of £30.208m and has utilised £30.863m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

No new long term external borrowing has been undertaking during the period.

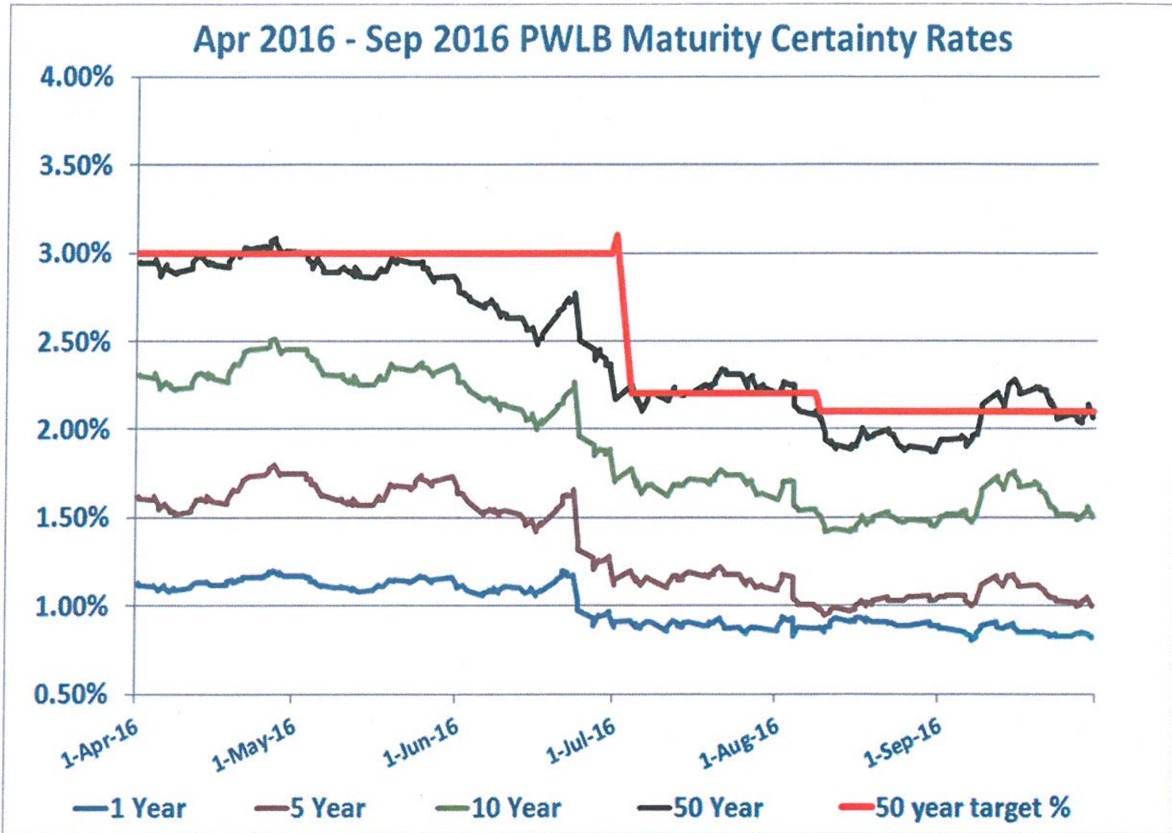
As shown in the graph below, the general trend during the period to September 2016 was a sharp fall in interest rates.

It is not anticipated that there will be a need for any long term external borrowing to be undertaken towards the end of the financial year.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year:-

PWLB certainty rates 1 April 2016 to 30TH September 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/9/16	0.83%	1.01%	1.52%	2.27%	2.10%
Low	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%

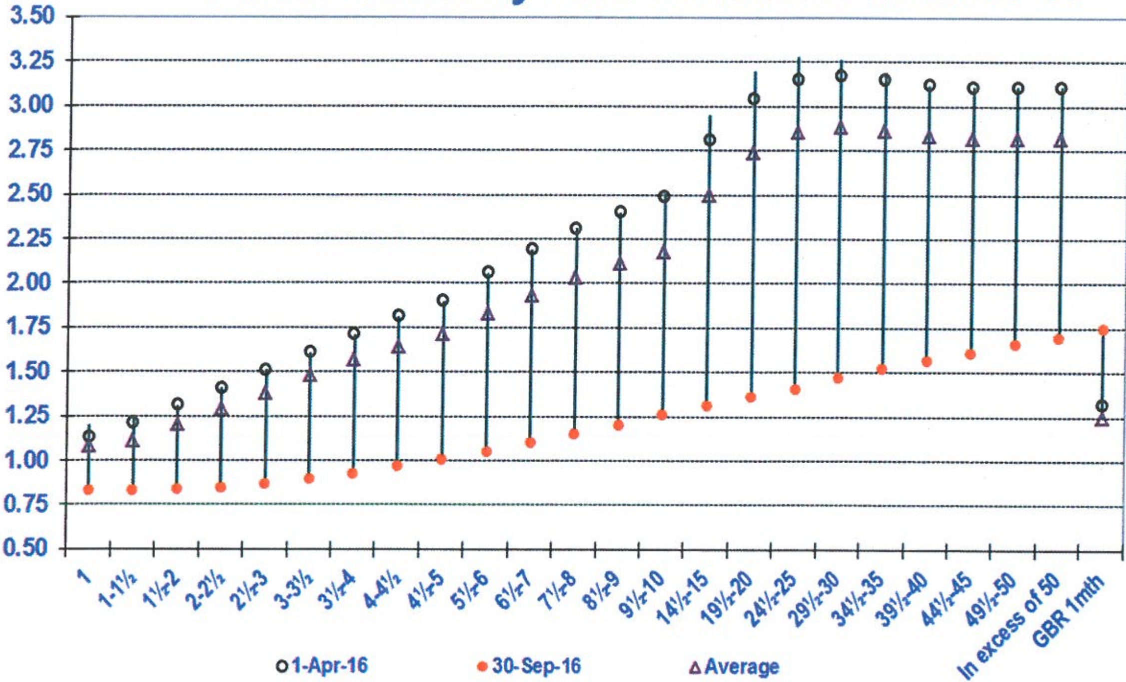


8 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010.

No debt rescheduling has therefore been undertaken to date in the current financial year.

APPENDIX 1: Borrowing



APPENDIX 2: Investment Rates

The graph below shows a comparison of the benchmark LBID rate compared with bank rate.