OFFICE OF THE POLICE AND CRIME COMMISSIONER
FOR HUMBERSIDE
DECISION RECORD

Decision Record Number: **45/2017**

Title: **Mid-Year Treasury Management Review Report 2017/18**

Executive Summary:
Report submitted that provided details of the Treasury Management activity undertaken during the period 1 April to 30 September 2017 following consideration and endorsement by the Joint Independent Audit Committee on 11 December 2017.

Decision:
That the Treasury Management Mid-Year Review Report 2016/17 be approved and that the proposal to increase the counterparty limits to £25m in any one institution and banking group be agreed.

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 13.12.2017**

HUMBERSIDE
POLICE & CRIME
COMMISSIONER

Police and Crime Commissioner for Humberside

Treasury Management
Mid-Year Review Report 2017/18

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 PCC's borrowing need, essentially the longer term cash flow planning to ensure the PCC can meet the 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 the PCC's 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."

1. Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by the PCC on 06.03.2017.

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 the PCC the delegated body is the Joint Independent Audit Committee (JIAC):

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 2017/18 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 2017/18;
- A review of the PCC's borrowing strategy for 2017/18;
- A review of any debt rescheduling undertaken during 2017/18;
- A review of compliance with Treasury and Prudential Limits for 2017/18.

2. Economics and interest rates

3.1 Economics update

After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC. The focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and with improvements within productivity being so weak, the amount of spare capacity in the economy was significantly diminishing and so they were now approaching a point at which action was needed. The MPC took a more tolerant view of low wage inflation as this now appears to be a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. The Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

As the MPC had effectively painted themselves into a corner at the meeting on 14 September 2017, it was a virtual certainty that Bank Rate would go up by 0.25% and this increases was duly delivered with a vote of 7-2 in favour of removing the post EU referendum emergency monetary stimulus implemented in August 2016 by reversing the cut in Bank Rate at that time from 0.5% to 0.25%, (with no change in QE this time).

In view of the robust rate of growth in the second half of 2016 which confounded the Bank's August 2016 forecasts for a sharp slowdown, many commentators subsequently held the view that that emergency action was unnecessary. On the face of it, to now increase Bank Rate when economic growth in 2017 in quarters 1 and 2 was so disappointingly weak, (0.2% and 0.3% respectively), can appear to be perverse.

The MPC also gave forward guidance that they expected to increase Bank Rate only twice more in the next two years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

The markets viewed this result as being more dovish than they had expected and sterling duly responded by falling 0.8% against the dollar and euro on the day. As this was the first increase in Bank Rate for a decade, the MPC was right to avoid alarming consumers and financial markets, and to be very reassuring about the pace of future increases.

The quarterly Inflation Report itself, was notably downbeat about economic growth based on a view that the trend rate of growth for the economy has now fallen from 2.2% to only 1.5%, (whereas in the decade before the financial crash it grew at 2.9% p.a.). One of the main focuses for this was a view that productivity growth would remain very weak at about only 1% p.a. This does not augur well for increases in wage rates. This, in turn, is likely to feed through into weak domestically generated, (i.e. excluding the one off post referendum imported inflation through the fall in the value of sterling), price pressures underpinning CPI inflation.

Overall, the Inflation Report was little changed from the August report and again forecast that inflation would be barely above the 2% target at the three year time horizon; it is also expected to peak very soon at 3.2%, (September was 3.0%), before falling thereafter as the devaluation effect gradually falls out of the 12 month statistics. As for forecasts for GDP growth, these also barely changed with growth falling from 1.7% to 1.6% for 2017 and being unchanged for 2018 (1.6%) and 2019 (1.8%). The MPC was also quite concerned about the situation over Brexit as there has been little significant agreement so far in terms of moving towards giving UK firms some confidence of what sort of trade terms the UK is likely to have with the EU from 2019. They felt that this uncertainty was holding back investment. The MPC's forecasts are predicated on an assumption that households and companies base their decisions on a smooth adjustment to a new trading relationship with the EU.

It has to be said that overall, this is really a quite pessimistic outlook for the UK economy. For some commentators, raising Bank Rate with such a weak outlook, did not sit easily together. However, the MPC's main justification for taking action now to raise Bank Rate was that because unemployment was at the lowest rate for 42 years at only 4.3%, there was little spare capacity left in the economy, especially when increases in productivity were expected to be so weak and taking account of Brexit caused expected falls in net immigration. They also noted that consumer confidence has remained resilient and the global economy was growing strongly which would help UK exports. In addition, financial conditions were highly accommodative through the current level of monetary policy. Accordingly, despite this weak outlook for GDP growth, they needed to take action now to ward off the potential for inflationary pressures to start building up.

3.2 Interest rate forecasts

The PCC's treasury advisor, Capita Asset Services has been acquired by Link Asset Services who now provide the service. The last interest rate review was undertaken on 9 August 2017 and Link Asset Services updated its forecast on 7 November 2017 following the MPC meeting.

The MPC made some obvious comments around the fact that the UK is going through a period of heightened uncertainty due, particularly, to the unknowns around how the Brexit negotiations will proceed and the likely effect on households and companies. They will adjust their responses according to how these turn out and in the light of how the economy progresses over the next two to three years. Link Asset Services agree with these qualifications. Obviously, if the negotiations are very difficult and end up being disappointing, this could put in jeopardy even two Bank Rate increases over the next two years.

Link Asset Services have indicated that they can only forecast given the current situation and have to flag up that there is a wide spread of potential outcomes during this forecast period. There is, therefore, a likelihood of heightened volatility as events actually unfold. However they see that the strong causal link in western economies between falling unemployment and rising inflation, appears to be broken. This has led some commentators to raise the question as to whether we are now moving into a new paradigm of low unemployment at the same time as low inflation, where central bank policy targets of focusing primarily on inflation are beginning to be called into fundamental question. The example of Japan, which has struggled for some two decades to get inflation up to 2% despite massive repeated rounds of QE, is just one example. What will actually happen to wage inflation, therefore, remains a key issue. If wage inflation continues to remain very subdued over the next two to three years, this will act as a significant headwind to the MPC justifying further increases in Bank Rate due to inflationary threats building up. However, it has in the past 'looked through' e.g. one off increases in inflation which it saw as a temporary occurrence; the MPC could, therefore, be flexible in implementing its mandate of focusing primarily on inflation. Alternatively, they could justify increases in Bank Rate as being primarily due to the need to simply remove monetary policy stimulus as this has caused massive distortions in the economy with asset prices e.g. share prices and house prices have been the main beneficiaries while savers have been the major losers through low interest rates.

The Link Asset Services' forecasts are cautious and in line with this subdued path for increases in Bank Rate. They do not currently see inflation posing a significant threat over the next three years and have 0.25% increases in November 2018 to 0.75%, 1.0% in November 2019 and 1.25% in August 2020. This is much in line with market expectations. The central assumption is that the UK will make progress with concluding a satisfactory outcome over the Brexit negotiations with the EU by March 2019, although the UK finance sector is likely to be an area of particular concern and difficulty.

Economic forecasting remains difficult with so many external influences weighing on the UK. 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. Volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds.

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

Link Asset Services have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between the two yields. They would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. This area will need to be monitored closely and any resulting effect on PWLB rates.

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

- The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

- The 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 period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea, which have a major impact on international trade and world GDP growth.

Link Asset Services continue to remind clients of the view that they have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. Their revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities, including both the Humberside and South Yorkshire PCCs, since 1st November 2012.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

The latest interest rate forecast is as follows:-

	Dec'17	Mar'18	Jun'18	Sep'18	Dec'18	Mar'19	Jun'19	Sep'19	Dec'19	Mar'20	Jun'20	Sep'20	Dec'20	Mar'21
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
3 month LIDIB	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
6 month LIBID	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
12 month LIBID	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
5 yr PWLB	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
10yr PWLB	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
25yr PWLB	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
50yr PWLB	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

3. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by the PCC on 06.03.2017 and there are no policy changes at this stage.

4. 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 by Service	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Total capital expenditure	**16.043**	**15.881**

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 supported and unsupported elements of the capital programme, 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	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Total capital expenditure	**16.043**	**15.881**
Financed by:		
Capital receipts	**-**	**0.430**
Capital grants	**0..698**	**0.698**
Capital reserves	**-**	**0.482**
Revenue	**-**	**-**
Total financing	**0.698**	**1.610**
Borrowing requirement	**15.345**	**14.271**

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

We are on target to remain within the original forecast Capital Financing Requirement.

Prudential Indicator – the Operational Boundary for external debt

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
TOTAL CFR	**73.956**	**71.644**
Net movement in CFR	**12.077**	**12.284**
Total debt (year-end position)	**42.126**	**41.052**

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 a 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 2017/18 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.

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Total debt	**42.126**	**41.052**
CFR (year-end position)	**73.956**	**71.644**

The Deputy Chief Executive and Treasurer reports 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 Members. 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	2017/18 Original Indicator	2017/18 Revised Indicator
Total	**82.799**	**90.926**

5. Investment Portfolio 2017/18

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 shown by forecasts in section 3.2, 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 level of the Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The PCC held £18.890m of investments as at 30 September 2017 and the investment portfolio yield for the first 6 months of the year is 0.34% against a benchmark average 7 day LIBID rate of 0.11%. .

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 2017/18.

The PCC's budgeted investment return for 2017/18 is £46k and performance for the year to date is in line with the budget.

Investment Counterparty criteria

The current investment counterparty criteria are proving restrictive given the level of investments held and it is proposed that the existing limit of £20m in any one banking group should be increased to £25m in any one institution and banking group.

6. Borrowing

The PCC's capital financing requirement (CFR) for 2017/18 is £71.644m. 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 will have estimated borrowings of £41.052m at the end of the financial year utilising £30.592m 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.

Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £2m from the PWLB was undertaken on 27 September2017 with a maturity loan at fixed interest of 2.37% repayable in 12 years on 27 September 2029.

It is anticipated that further borrowing will be undertaken during this financial year.

7. 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.

8. Other

1. Revised CIPFA Codes

The Chartered Institute of Public Finance and Accountancy, (CIPFA), has conducted an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code.
A particular focus of this exercise was to seek views on how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non treasury investments. Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on this authority.

2. MIFID II

The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on the PCC.