HUMBERSIDE
POLICE & CRIME
COMMISSIONER

Police and Crime Commissioner for Humberside

Treasury Management
Mid-Year Review Report
2019/20

1. Background

1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities have been required to prepare a Capital Strategy which is to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

1.2 Treasury management

The PCC operates a balanced budget, which broadly means cash raised during the year will meet 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 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 borrowing, 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

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 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. The PCC has delegated this to 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 2019/20 financial year;
- A review of the Treasury Management Strategy Statement, Annual Investment Strategy and Minimum Revenue Provision Policy;
- The PCC's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the PCC's investment portfolio for 2019/20;
- A review of the PCC's borrowing strategy for 2019/20;
- A review of any debt rescheduling undertaken during 2019/20;
- A review of compliance with Treasury and Prudential Limits for 2019/20.

3. Economics and interest rates

3.1 Economics update – April to September 2019

UK. The first half year was a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there was no deal by 31 October. At that stage MPs also voted down holding a general election before 31 October. There was no majority of MPs at that time for any one option to move forward on enabling Brexit to be implemented. The whole Brexit situation was highly fluid and likely to change radically by the day. In these circumstances and the likelihood of an imminent general election, any interest rate forecasts were recognised as being subject to material change as the situation evolved.

This period saw UK economic growth fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September re-emphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which were expecting a significant downturn or possibly even a recession in some major developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% and has done throughout 2019 and was expected to hold off on changes until there was some clarity on what is going to happen over Brexit.

On 29 October MPs voted to finally resolve their Brexit deadlock by calling a general election to be held on 12 December 2019. This was seen as possibly the most unpredictable election in a generation. Since then all of the major political parties have been making significant promises on various spending commitments. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth. Any loosening of monetary policy and could see medium to longer dated gilt yields rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

As for inflation, CPI was hovering around the Bank of England's target of 2%, but fell to 1.7% in August. It was considered likely to remain close to 2% over the next two years. Therefore it was not seen as posing any immediate concern to the MPC at that time but it was recognised that, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

The labour market, despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggested that firms were preparing to expand output and suggested there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall by another 11,000, with employers continuing to have difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, increases in household spending power is likely to feed through into providing some support to the overall rate of economic growth. GDP statistics included a revision of the savings ratio from 4.1% to 6.4%. This provided some reassurance that consumers' balance sheets were not over stretched and so able to support growth going forward. This meant that the MPC would need to consider carefully at what point to take action to raise Bank Rate as the pick-up in wage costs was consistent with a rise in core services inflation to more than 4% in 2020.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 was falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 was expected to fall further. The strong growth in employment numbers during 2018 reversed into a falling trend during 2019, indicating that a cooling economy, while inflationary pressures were also weakening. The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc.). It then cut rates again in September to 1.75% - 2.00% with the prospect of another cut of 25 bps in December. Investor confidence was badly rattled by the progressive ramping up of increases in tariffs President Trump had made on Chinese imports with China responding with increases in tariffs on American imports. This trade war was seen as depressing US, Chinese and world growth. In the EU, it was also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It was also impacting on developing countries dependent on exporting commodities to China.

EUROZONE. In the first half year**, g**rowth had been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appeared to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany was seen as being particularly vulnerable to a no deal Brexit depressing exports further and if President Trump were to impose tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels "at least through the end of 2019", but that was of little help to boosting short term growth. Consequently, it announced a third round of Targeted Longer-Term Refinancing Operations (TLTROs), providing banks with cheap borrowing every three months from September 2019 until March 2021. This meant that, although they would have only a two-year maturity, the Bank would be making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs included an incentive to encourage bank lending, capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth had gathered momentum. At its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it was doubtful whether this loosening of monetary policy would have much impact on growth and unsurprisingly, the ECB stated that governments would need to help stimulate growth by fiscal policy. On the political front, Austria, Spain and Italy were in the throes of forming coalition governments with some unlikely combinations of parties, raising questions around their likely endurance. Results of two German state elections started to put further pressure on the frail German CDU/SDP coalition government.

CHINA. Economic growth had been weakening over successive years, despite repeated rounds of central bank stimulus with medium term risks increasing. Major progress was seen as needing to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress was also seen as being required to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. The trade war with the US did not appear to be having a significant effect on GDP growth as some of the impact of tariffs were being offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

JAPAN – Japan continued to be struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. Little progress was being made on fundamental reform of the economy.

WORLD GROWTH. The trade war between the US and China was a major concern to financial markets and was seen as depressing worldwide growth, with any downturn in China expected to spill over into impacting countries supplying raw materials to China. Concerns were focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, although this was probably being overblown. The concerns resulted in government bond yields in the developed world falling significantly during 2019. It was regarded that if there were a major worldwide downturn in growth, central banks in most of the major economies would have limited ammunition available, in terms of monetary policy measures, given rates were already very low in most countries, (apart from the US), and there were concerns about how much distortion of financial markets had already occurred with the current levels of quantitative easing purchases of debt by central banks. The PMI survey statistics of economic health for the US, UK, EU and China had all been sub 50 which gave a forward indication of a downturn in growth, confirming investor sentiment that the outlook for growth during the rest of this financial year was weak.

3.2 Economic Update - post September 2019

In view of the significant issues that have taken place since the end of September a further commentary is warranted.

UK: The position was reviewed when the Bank of England produced its next quarterly Monetary Policy Report (Inflation Report) which was of course completed and considered against the uncertainties of where the UK will be after the general election on 12 December. In October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. However, it was thought that even if a Conservative Government gains an overall majority in the election, there will still be much uncertainty over the detail of a trade deal which will need to be negotiated by the current end of the transition period in December 2020. The Bank made a change in their Brexit assumptions to include a deal being eventually passed.
The Monetary Policy Report, led to increasing concerns among MPC members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. It voted 7-2 to maintain Bank Rate at 0.75% with two members sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises.
It was judged that the speed of recovery will be dependent on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. Inflation forecasts were cut – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021 and so inflation was seen to pose little concern.

USA: While the USA was not seen as heading towards a recession, the Fed had made three cuts in rates of 0.25% in 2019 in order to counter the slowdown in growth during this year.

Eurozone: The ECB was viewed as increasingly concerned by the headwinds facing the EZ economy as a whole, but especially the German and Italian economies. Germany was seen as being particularly exposed to a downturn in the world economy due to exports being a very important part of its economy. Italy just appeared stuck with weak growth and successive governments having done little to face up to major issues that need to be dealt with. The ECB therefore emphasised that while it can tinker at the edges with cuts in rates, and boosting liquidity in financial markets, the heavy lifting will have to be done by fiscal policy measures through national government action. Such siren noises have generally fallen on deaf ears in years gone by and Italy has again had a rap on its knuckles from the ECB for not doing enough to reduce its structural deficit.

CHINA: China's growth rate has been cooling during 2019, partly as a result of the trade war, despite repeated interventions by the central bank to boost growth through monetary easing.
The US tariff war with China continues to have an almost daily impact on markets.

JAPAN: As it has over the last two decades, Japan has remained mired in a battle with trying to get inflation consistently up from near zero, and with weak economic growth. Despite massive monetary policy measures, quantitative easing, and fiscal measures by the government, little has been chieved despite having its foot flat on the floor of the accelerator pedal of measures to stimulate growth.

3.2 Interest rate forecasts

At the end of the first half of the financial year, the PCC's treasury advisor, Link Asset Services, provided the following forecast:

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

This forecast was based on an assumption that there would be some sort of muddle through to an agreed deal on Brexit at some point. Given the level of uncertainty, this was a huge assumption and so it was recognised that forecasts would probably need to be materially reassessed in the light of forthcoming events.

There was little surprise that the Monetary Policy Committee (MPC) had left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That was shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion was that rates would need to rise at a "gradual pace and to a limited extent" was also conditional on "some recovery in global growth". Brexit uncertainty had had a dampening effect on UK GDP growth in 2019, especially around mid-year. With no deal Brexit, it was then thought likely that there would be a cut or cuts in Bank Rate to help support economic growth. The September MPC meeting sounded even more concern about world growth and the effect that prolonged Brexit uncertainty was likely to have on growth.

The interest rate forecasts were updated on 11 November 2019 as follows:

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	2.30	2.40	2.40	2.50	2.50	2.60	2.70	2.80	2.90	2.90
10yr PWLB Rate	1.50	2.60	2.70	2.70	2.70	2.80	2.90	3.00	3.10	3.20	3.20
25yr PWLB Rate	2.10	3.20	3.30	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90
50yr PWLB Rate	2.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60	3.60	3.70	3.80

The forecasts for UK Bank Rate, were little changed apart from the two increases being moved back by one quarter.

To make any forecast they had to make one central assumption – a reasonable muddle through outcome for Brexit. If the facts change, those forecasts will also change. As events unfold it is seen as possible that 25 – 50 bps movements in rates and yields could be seen at any time.

For PWLB rates, the underlying trend in gilt yields had been on a general falling trend in 2019 until 100 bps were added to all PWLB rates in October 2019 which is now reflected in the forecasts (see 7 below). Brexit developments and general election results, will impact gilt yields and PWLB rates going forward. It should be noted that at the revised PWLB rates there will be a need to consider alternative sources of borrowing or switching to short term borrowing in the money markets until such time as the Government might possibly consider the margins charged over gilt yields.

Link Asset Services have stressed that in the midst of such large-scale uncertainties the focus has to be on managing risk, rather than making gambling on one outcome or the other.

A key issue facing all central banks, except the US Fed, is that they have very little ammunition, in terms of normal monetary policy measures, to take action to counter the next economic downturn. The Bank of England and the MPC will have an agenda to restock their ammunition as soon as possible by raising Bank Rate when that becomes feasible, and, at a later time, possibly unwinding quantitative easing.

The general situation is for volatility in bond yields 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, although there are likely to also be periods of sharp volatility from time to time.

Link Asset Services latest forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within their 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 and Iran, which have a major impact on international trade and world GDP growth.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a Brexit deal is fully agreed with the EU, including the new terms of trade, and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- Bank of England takes action too quickly, or too far, 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.
- A resurgence of the Eurozone sovereign debt crisis. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new coalition based on an unlikely alliance of two very different parties will endure.
- Weak capitalisation of some European banks, particularly Italian banks.
- German minority government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in recent state elections but the SPD has done particularly badly and this has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.
- Other minority EU governments. Austria, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- Austria, the Czech Republic, Poland and Hungary now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.

- In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was potential for a rerun of the 2008 financial crisis, but this time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on some $19trn of corporate debt in major western economies, if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is $15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a downward spiral. The IMF's answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the Deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels.
- Geopolitical risks, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- Brexit – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary 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, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

3. Treasury Management Strategy Statement, Annual Investment Strategy and Minimum Revenue Provision Policy Update

3.1 TMSS and Investment Strategy

The Treasury Management Strategy Statement, (TMSS), for 2019/20, incorporating the Investment Strategy and Minimum Revenue provision Policy was approved by the PCC on 26 March 2019. This report updates the position in the light of the economic situation and budgetary changes already considered by the PCC.

Prudential Indicator 2019/20	Original £m	Revised Prudential Indicator £m
Authorised Limit	**112.562**	**105.401**
Operational Boundary	**110.562**	**103.401**
Capital Financing Requirement	**95.120**	**87.960**

3.2 Minimum Revenue Provision (MRP) Policy

In accordance with the Local Authorities (Capital and Accounting) (England) Regulations 2003 the PCC is required to make an annual contribution from revenue to repay long term borrowing, namely the "minimum Revenue Provision (MRP)"". Amendments introduced into Regulations in 2018 give authorities and PCCs the flexibility to set MRP at a level that is considered to be prudent. The broad aim of the guidance is to ensure that debt is repaid over a period that is reasonably commensurate with that over which the capital expenditure provides benefits.

The MRP Policy approved in March 2019 for 2019/20 was as follows:-

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- *Existing practice - MRP will follow the existing practice outlined in former MHCLG regulations which provides for an approximate 4% reduction in the borrowing need (CFR) each year.*

From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be:

- *Asset life method – MRP will be based on the estimated life of the assets, in accordance with the regulations and any expenditure capitalised under a Capitalisation Direction.*

The PCC's capital financing arrangements have been reviewed to compare the approach in Humberside with that being adopted by other PCCs and local authorities to assess the potential financial impact of the different options whilst ensuring that provision remains prudent and compliant with the guidance.

The legislation recommends that before the start of each year the PCC should prepare a statement of policy on making MRP in respect of that financial year. If it is proposed to vary the terms of the original MRP statement during the year then a revised statement is required to be put to the PCC for approval. It is proposed as part of this report that the PCC adopts a revised calculation for the MRP for 2019/20.

Revised guidance issued by MHCLG in 2018 updated the statutory guidance on determining a prudent level of MRP. The guidance sets out four options:-

Option 1 – The Regulatory Method
MRP is equal to the amount determined in accordance with the former Regulation 28 and 29 of the 2003 Regulations as if they had not been revoked by the amendment to those regulations. This involved adjustments in relation to Housing Revenue Account capital financing. This has not been considered as part of this review.

Option 2 – CFR Method
MRP is equal to 4% of the Capital Financing Requirement at the end of the preceding financial year

Option 3 - Asset Life Method
Where capital expenditure is financed from borrowing or credit arrangements, MRP is to be determined by reference to the useful life of the asset.
Under this option, there are two main methods for calculating the amount:-

(a) Equal Instalment Method
(b) Annuity Method

Option 4 – Depreciation Method
MRP is deemed to be equal to the provision required in accordance with depreciation accounting in respect of the asset on which the expenditure has been financed by borrowing. This is not considered appropriate and appears to be little used in local authorities.

The guidance suggests that Options 1 and 2 should only be used in relation to capital expenditure incurred before 1 April 2008. Options 3 and 4 provide prudent approaches for expenditure incurred after 1 April 2008 and having reviewed the approach adopted in other authorities and supported by external auditors it is clear Options 3 and 4 can be used and are not prohibited in respect of expenditure pre 2008.

Although the guidance makes it clear that other methodologies are permissible alternatives have not been considered at this stage.

The PCC has continued to adopt Option 2, the CFR approach in respect of pre-2007/08 debt as indicated above along with use of the asset life method of calculating the MRP for borrowing after that date by setting aside each year an amount that in simple terms equalled approximately 4% of the amount of capital expenditure financed from borrowing.

For post 2007/08 borrowing the asset life method has been used to calculate the element of the MRP using the equal instalment method.

From 1 April 2019, it is proposed that Option 3 be adopted, using the annuity method for calculating the MRP and that rate and amortisation period shall be determined by the PCC's Chief Finance Officer.

The annuity method is now widely used as it makes provision for an annual charge to revenue that takes account of the time value of money (whereby £100 in 10 years tome is less of a burden than paying £100 now. The charges produced by the annuity method result in a consistent charge over the life of the asset taking into account he real value of the annual charges when they fall due. The method also reflects the fact that assets deteriorate and deterioration is slower in the early years and accelerates towards the latter end of the life of the assets. This approach conforms to the MHCLG requirement to make a prudent provision over a period which is broadly commensurate with the period that the capital expenditure provides benefit. The annuity calculation method results in lower MRP payments in the early years but higher payment in later years but has the advantage of linking MRP to the flow of benefits from an asset where these are expected to be in later years.

The proposal if adopted will be subject to external audit as part of the annual accounts process.

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.

4.1 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	2019/20 Original Estimate £m	2019/20 Revised Estimate £m
Total capital expenditure	15.487	11.612

4.2 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	2019/20 Original Estimate £m	2019/20 Revised Estimate £m
Total capital expenditure	15.487	11.612
Financed by:		
Capital receipts	-	0.215
Capital grants	0.713	0.713
Capital reserves	-	-
Revenue	-	-
Total financing	0.713	0.928
Borrowing requirement	14.774	10.684

4.3 Prudential Indicators - the Capital Financing Requirement (CFR)

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purposes.

	2019/20 Original Estimate £m	2019/20 Revised Estimate £m
Capital Financing Requirement		
Total CFR	**95.120**	**87.960**
Net movement in CFR	**10.633**	**7.069**

The changes have occurred as a result of underspending in 2018/19 and slippage together with delays in schemes within the capital programme for the current year. This includes revisions to the profile of the Melton 2 project as well as slippage on schemes in Scunthorpe, Grimsby and Beverley and variations in forecast spending on IT, vehicles and equipment.

4.4 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 purpose. 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 2019/20 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.

Operational Boundary	2019/20 Original Estimate £m	2019/20 Revised Estimate £m
Operational Boundary	**110.562**	**104.401**
Total debt at 30 September 2019	**63.670**	**63.670**

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	2019/20 Original Indicator £m	2019/20 Revised Indicator £m
Authorised Limit		
Total debt at 30 September 2019	**63.670**	**63.670**

5. Investment Portfolio 2019/20

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 current 0.75% 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 £21.3m of investments as at 30 September 2019 (£2.3m at 31 March 2019) and the investment portfolio yield for the first six months of the year was 0.78% against the benchmark average7-day LIBID rate of 0.57 %.

The Deputy Chief Executive and Treasurer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2019/20.

Investment Counterparty criteria

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

6. Borrowing

The PCC's capital financing requirement (CFR) for 2019/20 was originally estimated at £95.120m. 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. This has proved to be a prudent and cost effective approach in light of recent economic conditions. Following a balance sheet review undertaken by Link Asset Services reference was made to the fact that this approach would need to be carefully monitored in view of the impact of the proposed draw down of reserves on the overall cash position. This monitoring will be undertaken in conjunction with the continuing review of the upside risk to gilt yields along with PWLB and other market rates.

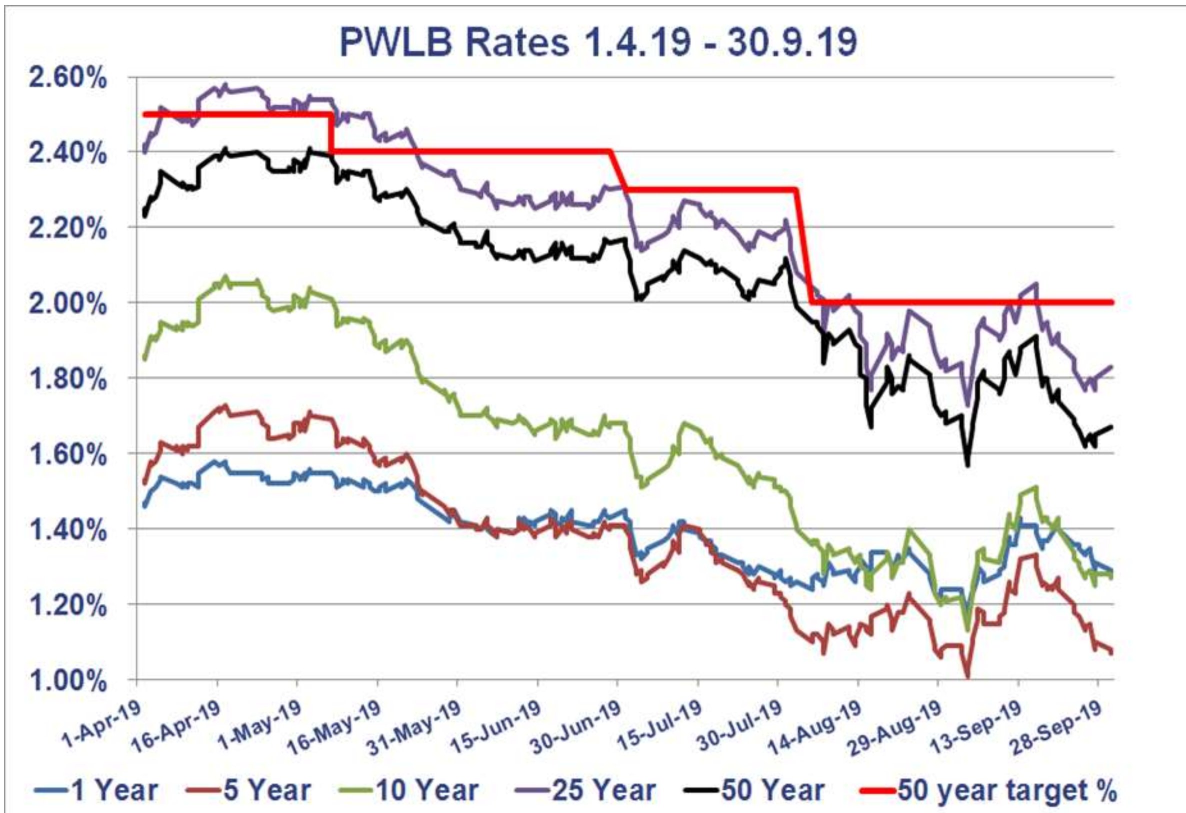
It is anticipated that external borrowing will need to be undertaken during this financial year.

From 1 November 2012, the Government introduced the Certainty Rate which reduced the PWLB standard interest rate by 20 basis points (0.20%) on loans from PWLB to principal local authorities who provide information as required on their plans for long-term borrowing and associated capital spending. The PCC has provided this information and has had access to these rates.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date. PWLB rates had been on a falling trend during this period and longer rates almost halved to reach historic lows. The 50 year PWLB target (certainty) rate for new long term borrowing fell from 2.50% to 2.00%.

During this period and towards the end of 2018/19, local authorities substantially increased their use of PWLB Funding. The Board's interest rates are determined by HM Treasury in accordance with section 5 of the National Loans Act 1968. In practice, this means that rates are set by the Debt Management Office (DMO) on HM Treasury's behalf. In response to the increased activity, bearing in mind the Government's approved limits, they moved to restore interest rates to the levels available in 2008.

On 9 October 2019, they did so by increasing the fixed margin above the Government's cost of borrowing, as measured by gilt yields. A 1% increase was applied to all new loans with immediate effect. This is reflected in the updated interest forecast at 3.2 above. It was imposed without advance notice and consultation. The Government has indicated however that the impact of this change and rates policy will be keep under review and there are suggestions that alternative competitive sources of loan finance within the money markets will be developed in response.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.01%	1.13%	1.73%	1.57%
Date	03/09/2019	03/09/2019	03/09/2019	03/09/2019	03/09/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.40%	1.37%	1.62%	2.20%	2.07%

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.

APPENDIX 1: borrowing