HUMBERSIDE
POLICE & CRIME
COMMISSIONER

Police and Crime Commissioner for Humberside
Annual Treasury Management Review
2017/18

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Annual Treasury Management Review 2017/18

Purpose

This PCC is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2017/18. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2017/18 the minimum reporting requirements were that the PCC should receive the following reports:

- an annual treasury strategy in advance of the year (06/03/2017)
- a mid-year treasury management review report (13/12/2017)
- an annual review following the end of the year describing the activity compared to the strategy, (this report)

The regulatory environment places responsibility of the treasury management policy and activities after they have been scrutinised by the Joint Independent Audit Committee (JIAC) on the PCC. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the PCC's previously approved policies.

This confirms that the requirements under the Code have been complied with.

Scrutiny of all of the above treasury management reports has been delegated to the JIAC. The JIAC consider the reports before they are reported to the full PCC.

Members of the JIAC received a detailed briefing on treasury management issues in August 2017 in order to support their scrutiny role.

Executive Summary

During 2017/18, the PCC complied with the legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2016/17 Actual £000	2017/18 Original £000	2017/18 Revised £000	2017/18 Actual £000
Capital expenditure	4,933	16,043	15,881	15,177
Capital Financing Requirement:	59,360	73,956	71,644	70,680
Gross borrowing				
- External debt PWLB	29,207	42,126	41,052	41,218
- Temporary Borrowing				4,000
Total Borrowing	29,207	42,126	41,052	45,218
Investments	3,200	1,000	1,000	3,800
Net borrowing	26,007	41,126	40,126	41,418

Other prudential and treasury indicators are to be found in the main body of this report. The Deputy Chief Executive and Treasurer that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, (the authorised limit), was not breached.

The financial year 2017/18 continued the challenging investment environment of previous years, namely low investment returns.

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the PCC's underlying indebtedness, (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the PCC has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. The PCC's Capital Expenditure and Financing 2017/18

The PCC undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the PCC's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m General Fund	2016/17 Actual £'000	2017/18 Original £'000	2017/18 Revised £000	2017/18 Actual £'000
Capital expenditure	4,933	16,043	15,881	15,177
Financed by: - Capital Receipts		-	430	590
- Capital Grants		698	698	698
- Capital Reserves		-	482	482
- Revenue		-	-	100
Total Financing	2,818	698	1,610	1,870
Borrowing requirement	2,115	15,345	14,271	13,307

2. The PCC's Overall Borrowing Need

The PCC's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the PCC's indebtedness. The CFR results from the capital activity of the PCC and resources used to pay for the capital spend. It represents the 2017/18 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the PCC's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, Treasury Officers organise the PCC's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising the PCC's cash resources temporarily in lieu of borrowing.

Reducing the CFR – the PCC's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The PCC is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP) which reduces the CFR. This is effectively a repayment of the PCC's borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The PCC's 2017/18 MRP Policy, (as required by MHCLG Guidance), was approved as part of the Treasury Management Strategy Report for 2017/18 in March 2017.

The PCC's CFR for the year is shown below, and represents a key prudential indicator.

CFR (£m):	31 March 2017 Actual	31 March 2018 Actual
Opening balance	59,933	59,360
Add unfinanced capital expenditure (as above)	2,115	13,307
Less MRP	2,688	1,987
Closing balance	59,360	70,680

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the PCC should ensure that gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2016/17) plus the estimates of any additional capital financing requirement for the current (2017/18) and next two financial years. This essentially means that the PCC is not borrowing to support revenue expenditure. This indicator allows the PCC some flexibility to borrow in advance of the immediate capital needs. The table below highlights the PCC's gross borrowing position against the CFR. The PCC has complied with this prudential indicator.

	31 March 2017 Actual £'000	31 March 2018 Budget £'000	31 March 2018 Actual £'000
Gross borrowing position	£29,207	41,052	45,218
CFR	£59,360	72,443	70,680

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the PCC does not have the power to borrow above this level. The table below demonstrates that during 2017/18 the PCC has maintained gross borrowing within the authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the PCC during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	Actual 2016/17 £'000	Original 2017/18 £'000	Actual 2017/18 £'000
Authorised limit	78,804	82,799	90,926
Maximum gross borrowing position	34,986	41,052	45,218
Operational boundary	76,804	80,799	88,926
Financing costs as a proportion of net revenue stream		2.80%	1.73%

3. Treasury Position as at 31 March 2018

The PCC's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through reporting detailed in the summary, and through officer activity detailed in the PCC's Treasury Management Practices (TMPs). At the end of 2017/18 the PCC's treasury, position was as follows:

TABLE 1	31 March 2017 Principal	Rate/ Return	Average Life yrs	31 March 2018 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:						
-PWLB	£29,207	3.36%	5.87	£41,281	2.94%	5.68
Variable rate funding:						
-Market	-			£4,000	0.80%	N/A
Total debt	**£29,207**			**£45,281**		
CFR	**£59,360**			**£70,680**		
Over / (under) borrowing	**£30,153**			**£25,399**		
Investments:	£3,200	0.46	N/A	£3,800	0.40%	N/A
Total investments	**£3,200**			**£3,800**		

The maturity structure of the debt portfolio was as follows:

	31 March 2017 actual	31 March 2018 actual
Under 12 months	£2,426	£3,404
12 months and within 24 months	£3,404	£3,411
24 months and within 5 years	£10,114	£9,969
5 years and within 10 years	£10,731	£11,647
10 years and above	£2,532	£12,850

The maturity structure of the investment portfolio was as follows:

	2016/17 Actual £000	2017/18 Original £000	31 March 2018 Actual £000
Investments Under 1 year	3,200	1,000	3,800

The PCC maintained an under-borrowed position. This meant that the capital borrowing need (the Capital Financing Requirement), was not fully funded with loan debt as cash supporting the PCC's reserves, balances and cash flow was used as a temporary measure. This strategy was prudent as investment returns were low and counterparty risk was still an issue that needed to be considered.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Deputy Chief Executive and Treasurer therefore monitored interest rates in financial markets and adopted a pragmatic strategy to manage interest rate risks.

4. The Strategy for 2017/18

The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31.3.20. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

In 2017/18, longer term PWLB rates were volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

5. The Economy and Interest Rates

The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of **1.8% in 2016**, (actually joint equal with Germany), and followed it up with another **1.8% in 2017**, (although this was a comparatively weak result compared to the US and EZ).

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year; quarter 1 came in at +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 EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

Consequently, market expectations during the autumn rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The **MPC meeting of 14 September** provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon. The **2 November MPC quarterly Inflation Report meeting** duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016. Market debate then moved on as to whether this would be a one and done move for maybe a year or more by the MPC, or the first of a series of increases in Bank Rate over the next 2-3 years. The MPC minutes from that meeting were viewed as being dovish, i.e. there was now little pressure to raise rates by much over that time period. In particular, the GDP growth forecasts were pessimistically weak while there was little evidence of building pressure on wage increases despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching of its 2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. So this all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise. The **8 February MPC meeting** minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift

in market expectations resulted in **investment rates** from 3 – 12 months increasing sharply during the spring quarter.

PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to **US treasuries**. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

As for **equity markets**, the FTSE 100 hit a new peak near to 7,800 in early January before there was a sharp sell-off in a number of stages during the spring, replicating similar developments in US equity markets.

The major UK landmark event of the year was the inconclusive result of the **general election** on 8 June. However, this had relatively little impact on financial markets. However, **sterling** did suffer a sharp devaluation against most other currencies, although it subsequently recovered. Brexit negotiations have been a focus of much attention and concern during the year.

The **manufacturing sector** has been the bright spot in the economy, seeing stronger 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, the manufacturing sector only accounts for around 11% of GDP so expansion in this sector has a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing to stimulate growth. However, growth eventually picked up in 2016 and subsequently gathered further momentum to produce an overall GDP figure for 2017 of 2.3%. Nevertheless, despite providing this massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in March, inflation was still only 1.4%. It is, therefore, unlikely to start an upswing in rates until possibly towards the end of 2019.

Growth in the American economy was volatile in 2015 and 2016. 2017 followed that path again with quarter 1 at 1.2%, quarter 2 3.1%, quarter 3 3.2% and quarter 4 2.9%. The annual rate of GDP growth for 2017 was 2.3%, up from 1.6% in 2016. Unemployment in the US also fell to the lowest level for 17 years, reaching 4.1% in October to February, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has been the first major western central bank to start on an upswing in rates with six increases since the first one in December 2015 to lift the central rate to 1.50 – 1.75% in March 2018. There could be a further two or three increases in 2018 as the Fed faces a challenging situation with GDP growth trending upwards at a time when the recent Trump fiscal stimulus is likely to increase growth further, consequently increasing inflationary pressures in an economy which is already operating at near full capacity. In October 2017, the Fed also became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in reinvesting maturing debt.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and medium term risks are increasing. Major progress still needs 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.

GDP growth has been improving to reach an annual figure of 2.1% in quarter 4 of 2017. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, although inflation has risen in 2018 to reach 1.5% in February. It is also making little progress on fundamental reform of the economy.

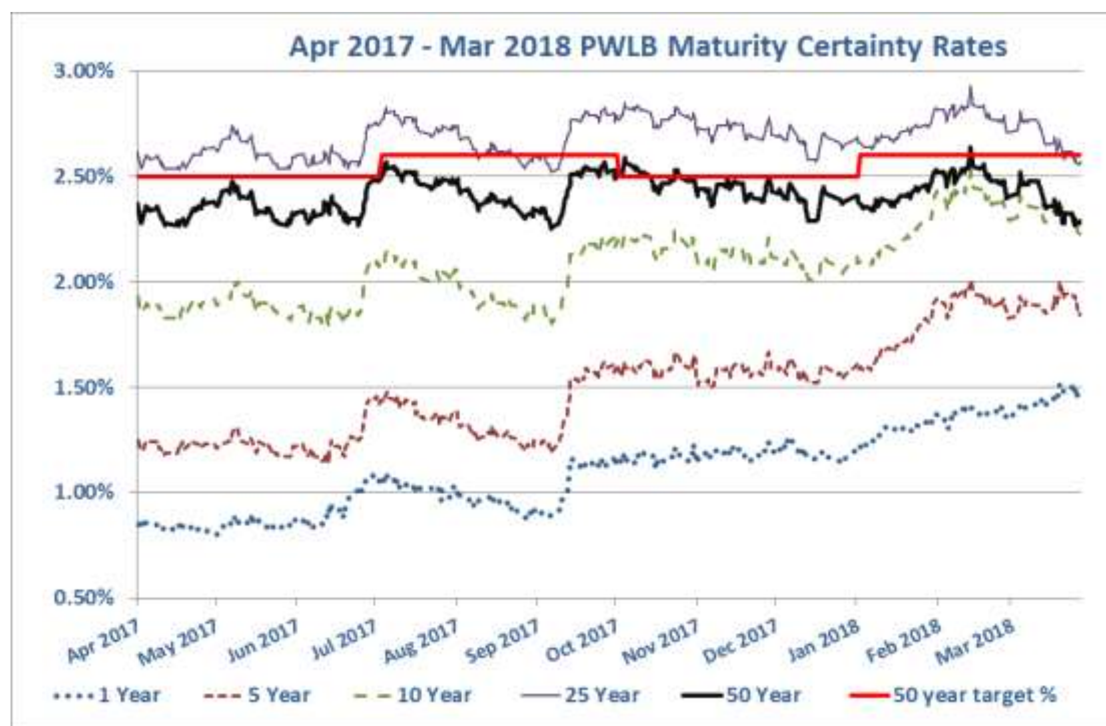
6. Borrowing Rates in 2017/18

PWLB certainty maturity borrowing rates

As depicted in the graph and tables below and in appendix 3, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March.

During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4.

The graphs and tables for PWLB rates show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



7. Borrowing Outturn for 2017/18

Treasury Borrowing

Borrowing - loans were drawn down during the year to fund unfinanced capital expenditure and naturally maturing debt.

The loans drawn were:

Date	Lender	Principal	Type	Interest Rate %	Maturity
29/09/2017	PWLB	2,000,000	Maturity	2.37%	17/09/2029
19/01/2018	PWLB	2,000,000	Maturity	2.36%	19/01/2031
19/01/2018	PWLB	2,000,000	Maturity	2.15%	19/01/2028
19/01/2018	PWLB	1,000,000	Maturity	2.07%	19/01/2027
19/01/2018	PWLB	1,000,000	Maturity	1.88%	19/01/2025
15/02/2018	PWLB	2,000,000	Maturity	2.68%	15/02/2033
20/03/2018	PWLB	2,500,000	Maturity	2.51%	20/03/2032
20/03/2018	PWLB	2,000,000	Maturity	2.57%	20/03/2034
	TOTAL	14,500,000			

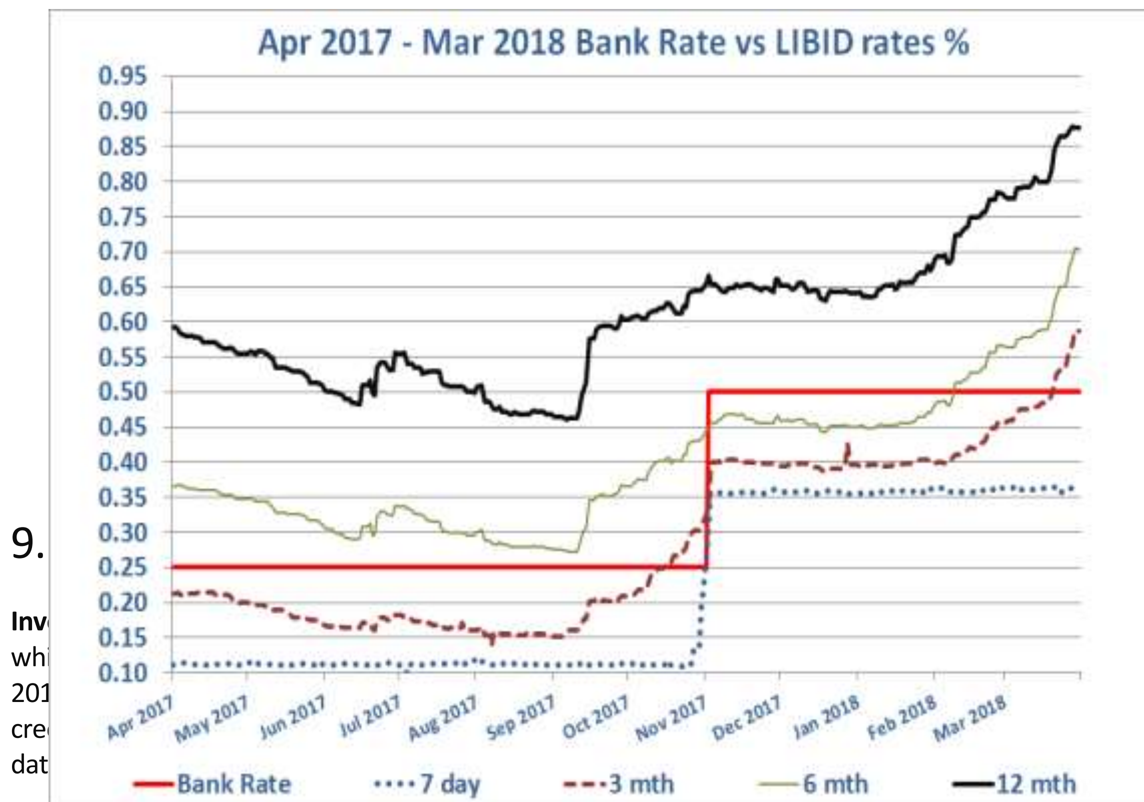
Rescheduling
No rescheduling was done during the year. The average 1% differential between PWLB new borrowing rates and premature repayment rates now seriously prohibits rescheduling.

Repayments
The PCC repaid £2.426m of external PWLB debt in 2017/18.

Summary of debt transactions
The management of the debt portfolio in 2017/18 resulted in a fall in the average interest rate of 0.42%.

8. Investment Rates in 2017/18

Investment rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March.
Bank Rate was duly raised from 0.25% to 0.50% on 2.11.17 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28.2.18.



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The investment activity during the year conformed to the approved strategy, and the PCC had no liquidity difficulties.

Resources – the PCC's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Investments held by the PCC - The internally managed funds earned an average rate of return of 0.35%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.36%.

10. Other Issues

Revised CIPFA Codes

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

A particular focus of these revised codes was 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 at a much higher level than can be attained by treasury investments.

One recommendation was 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 have been apportioned between treasury and non-treasury investments. Due to the nature of the PCC's treasury management activities the new codes are unlikely to have a significant impact other than the requirement to produce during 2018/19 with full implementation in 2019/20.

Markets in Financial Instruments Directive II (MiFID II)

The EU set the date of 3 January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on the PCC due to the form of investment that are restricted to cash deposits with banks and building societies.

Appendix 1: Prudential and treasury indicators

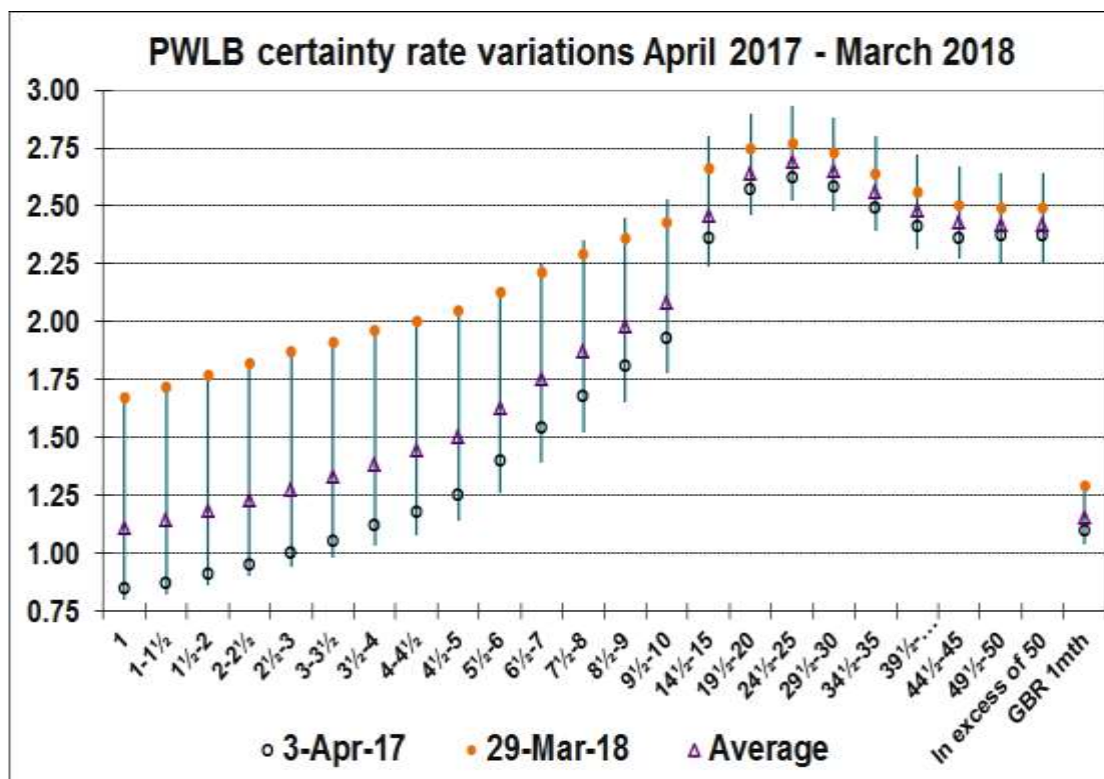
1. PRUDENTIAL INDICATORS	2016/17	2017/18
Extract from budget and rent setting report	**actual**	**actual**
	£'000	**£'000**
Capital Expenditure	£4,933	£15,177
Ratio of financing costs to net revenue stream	2.15%	1.73%
Gross borrowing requirement General Fund		
brought forward 1 April	£31,947	£29,207
Loans repaid in year/New borrowing	-2,940-	£16,074
carried forward 31 March	£29,207	£45,281
Gross debt	£29,207	£45,281
CFR	£59,360	£70,680
Annual change in Cap. Financing Requirement	£(573)	£11,320

Appendix 2: Graphs

UK, US and EZ GDP growth

Inflation UK, US, Germany and France

Appendix 3: Borrowing and investment rates



	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
3/4/17	0.850%	0.870%	1.000%	1.120%	1.250%	1.930%	2.620%	2.370%	1.100%
29/3/18	1.670%	1.720%	1.870%	1.960%	2.050%	2.430%	2.770%	2.490%	1.290%
High	1.510%	1.600%	1.790%	1.900%	2.010%	2.530%	2.930%	2.640%	1.310%
Low	0.800%	0.820%	0.940%	1.030%	1.140%	1.780%	2.520%	2.250%	1.040%
Average	1.107%	1.143%	1.276%	1.384%	1.503%	2.083%	2.688%	2.415%	1.157%
Spread	0.710%	0.780%	0.850%	0.870%	0.870%	0.750%	0.410%	0.390%	0.270%
High date	21/03/2018	21/03/2018	21/03/2018	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018	21/03/2018
Low date	03/05/2017	03/05/2017	30/05/2017	15/06/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017	04/04/2017

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/17	0.85%	1.25%	1.93%	2.62%	2.37%
31/3/18	1.67%	2.05%	2.43%	2.77%	2.49%
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.51%	2.01%	2.53%	2.93%	2.64%
Date	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018
Average	1.11%	1.50%	2.08%	2.69%	2.41%

Money market investment rates 2017/18

	7 day	1 month	3 month	6 month	1 year
1/4/17	0.111	0.132	0.212	0.366	0.593
31/3/18	0.364	0.386	0.587	0.704	0.878
High	0.366	0.390	0.587	0.704	0.879
Low	0.099	0.122	0.140	0.273	0.461
Average	0.215	0.233	0.286	0.401	0.606
Spread	0.267	0.268	0.447	0.432	0.418
High date	27/2/18	22/3/18	29/3/18	29/3/18	28/3/18
Low date	4/7/17	10/8/17	7/8/17	7/9/17	6/9/17