DECISION PAPER

DECISION: 2017/34	DATE: 15/11/2017
TITLE: TREASURY MANAGEMENT MID YEAR REPORT 2017-2018	
REPORT BY: STEVE FREEMAN, CHIEF FINANCE OFFICER	

Executive Summary

In accordance with the CIPFA Treasury Management code of practice this report provides information on treasury management activity that has been undertaken in the current financial year and reports on the overall performance against the agreed strategy and prudential indicators.

Recommendation

The Police and Crime Commissioner is asked to note the report.

Signature Clive Grunshaw

Police and Crime Commissioner

Date 20th November 2017

1. **Background & Advice**

REVIEW OF TREASURY MANAGEMENT 2017/18 Mid-Year Report

Economic Overview

The key economic messages in the period were increasing inflation, falling unemployment but reductions in real wages. The Consumer Price Inflation (CPI) index rose in August to 2.9%, its highest since June 2013. This increase was largely due to the fall in the value of sterling following the June 2016 referendum which has led to higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, which is the lowest rate since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of calendar 2017.

The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". Subsequently at the MPC meeting of the 2nd November the base rate was raised to 0.5%.

Global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25%. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme.

However geopolitical tensions escalated in August as the US and North Korea exchanged verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen.

Prime Minister Theresa May called an unscheduled General Election in June, result of which has led to a minority Conservative government with support from the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. The uncertainty around future trade relations with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

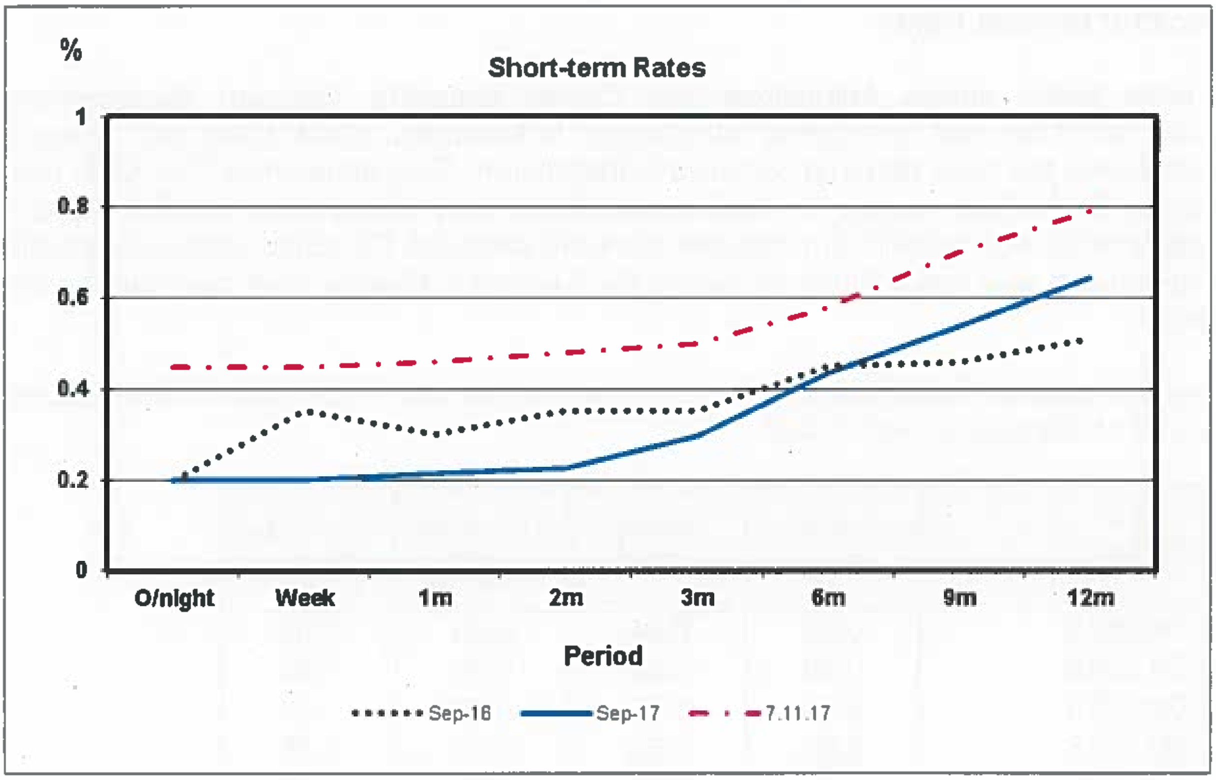
Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September.

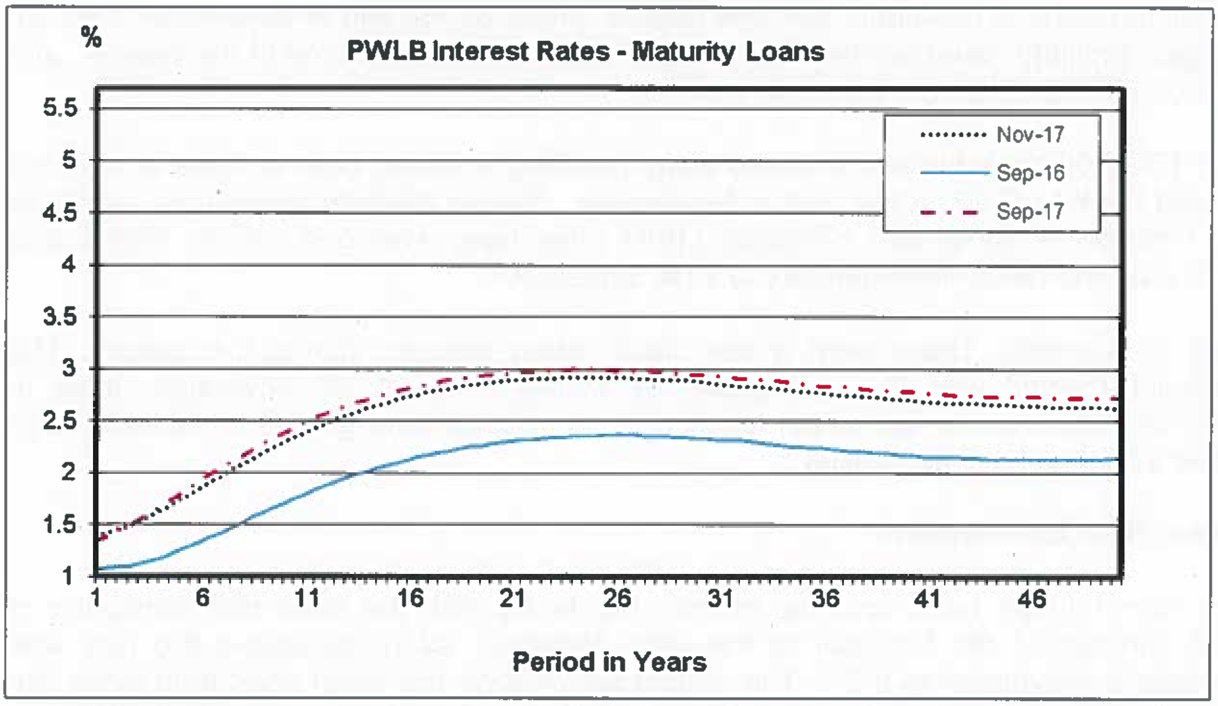
Credit background: There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

Interest Rate Environment

Short term interest rates continue at very low levels with the base rate remaining at 0.25% throughout the first half of the year. However, as noted above the rate was increased in November to 0.5%. The graphs below show the latest short term rates and for comparison the rates that were available at the end of September 2016 and 2017.



Current longer term PWLB rates are shown below.



Outlook for Interest Rates

The table below shows Arlingclose, the County Council's Treasury Management advisors, latest forecast for interest rates issued in November which takes into account the increase in the base rate that occurred in that month. They stated that "The MPC has increased Bank Rate, largely to meet expectations they themselves created. Future expectations for higher short term interest rates are subdued. On-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions.

Our central case for Bank Rate is 0.5% over the medium term. The risks to the forecast are broadly balanced on both sides".

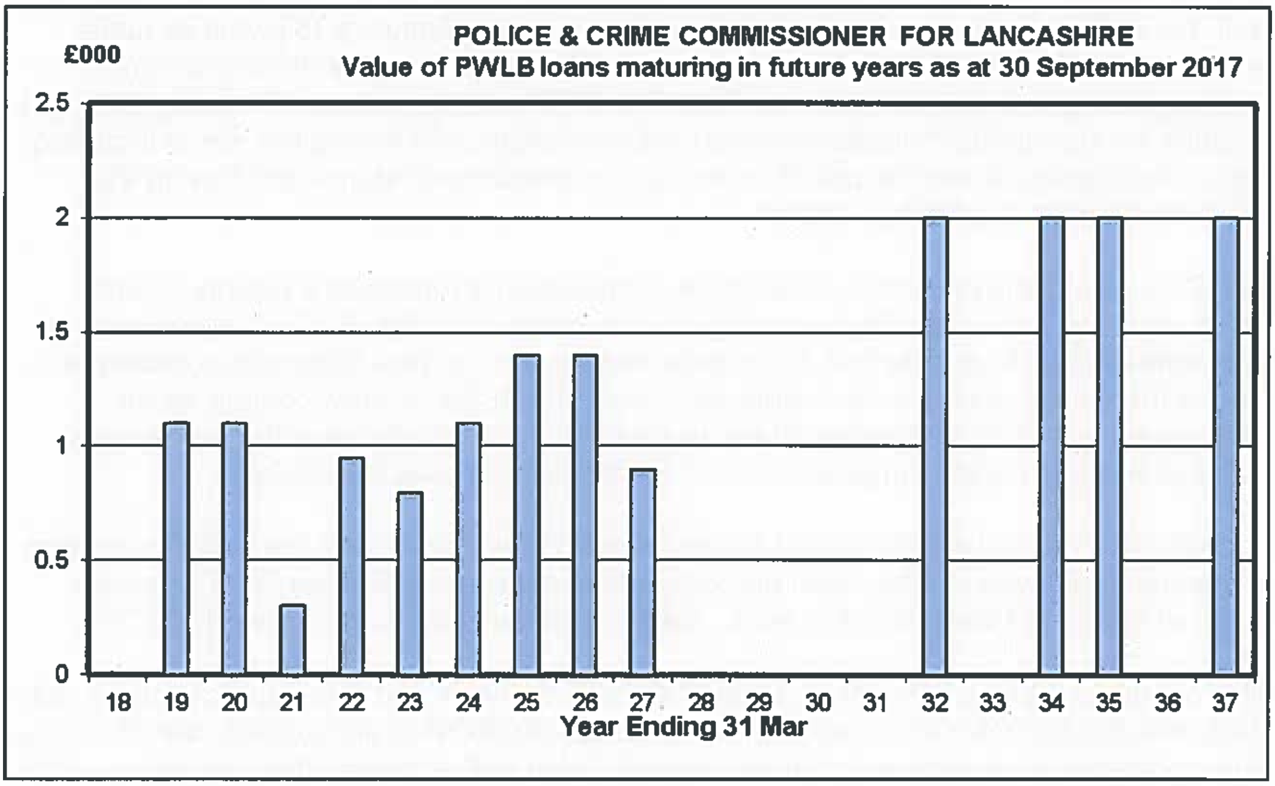
Period	Bank Rate	3 month LIBID	12 month LIBID	20-year Gilt Rate
Q4 2017	0.50	0.50	0.70	1.85
Q1 2018	0.50	0.50	0.70	1.85
Q2 2018	0.50	0.50	0.70	1.85
Q3 2018	0.50	0.50	0.70	1.85
Q4 2018	0.50	0.50	0.80	1.85
Q1 2019	0.50	0.50	0.80	1.90
Q2 2019	0.50	0.50	0.80	1.90
Q3 2019	0.50	0.50	0.80	1.95
Q4 2019	0.50	0.50	0.80	1.95
Q1 2020	0.50	0.50	0.80	2.00
Q2 2020	0.50	0.50	0.80	2.05
Q3 2020	0.50	0.50	0.80	2.05

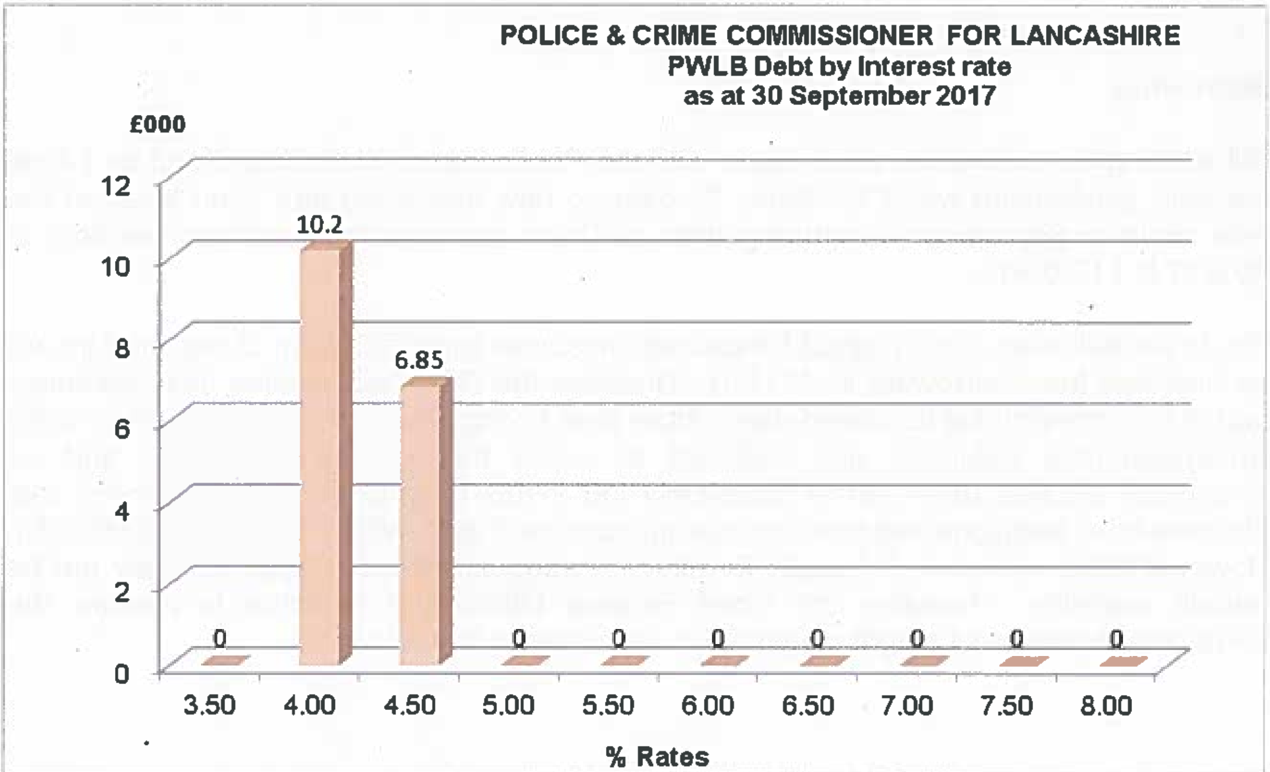
Borrowing

All existing borrowing has been taken with the Public Loans Work Board and at 1 April the debt outstanding was £18.154m. To date no new borrowing has been taken in the year while in September a maturing debt of £1.1m was repaid. Therefore the debt at 30.9.17 is £17.054m.

The latest estimate of the Capital Programme assumes that £20.227m of expenditure will be financed from borrowing in 2017/18. However the PCC has surplus cash balances and at the moment this has been used rather than taking new borrowing. At present the Commissioner's balances are sufficient to cover this internal borrowing and as investment interest rates are at historically low levels internal borrowing is more cost effective than traditional external borrowing from the Public Works Loan Board (PWLB). However initial cash-flow forecasts for 2018/19 suggest the cash balances may not be remain available. Therefore the Chief Finance Officer will continue to monitor the borrowing strategy in the light of economic and interest rate forecasts.

The charts over the page show the current maturity profile of the Commissioner's borrowings, along with an analysis of the debt by interest rate.





Investments

Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The PCC's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving low investment returns and having the value of reserves eroded by inflation.

The PCC principally invests in a call account provided by Lancashire County Council which pays the base rate. Each working day the balance on the PCC's Current Account is invested in this to ensure that the interest received on surplus balances is maximised. During the period all new investments were placed with the County Council via this arrangement. At 30th September there was a balance of £32.917m in the call account with the average balance invested in LCC for the period being £34.683m.

In addition to the call account with LCC investments held at 30.9.17 are a £5m long term investment held with another local authority which matures in October 2017. A senior secured bond fund was closed in April. Total investments at 30.9.17 are £37.917m.

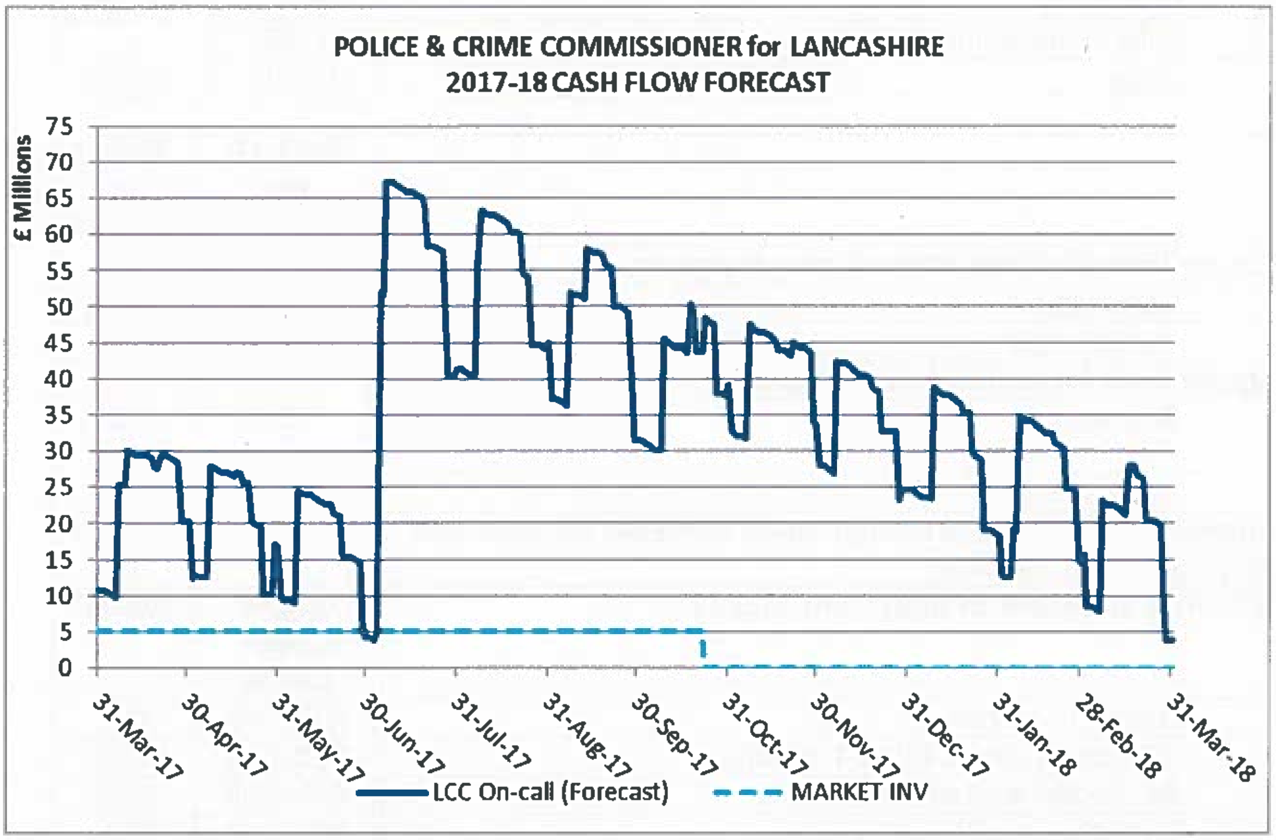
The overall combined amount of interest earned on fixed and call balances as at 30th September is £0.081m on an average balance of £39.683m at an average rate of 0.41%. This compares favourably with the benchmark 7 day notice index which averages 0.24% over the same period.

The opportunity to fix investments longer term to generate additional interest income is dependent upon future cash flows. The section below provides information on the cash flow to date and the estimated cash flows to the end of the year. This shows a reducing cash balance but that there is still sufficient cash to consider the opportunity to place a longer term investment.

The chart below shows the current interest rates for different investment maturities. In order to increase the rate earned on current balances, the commissioner would need to place fixed investments of at least 3 months duration but this would be dependent upon a counter party with a sufficient credit rating.

Cash Flow

The estimated cash flow totals are as follows:



This graph shows the total cash level held by the Authority. There is a regular pattern as cash is bolstered by precept receipts each month followed by falls as expenditure is incurred. The large cash injection from the low point at the beginning of July is the pensions top up grant. The blue line shows how much of the Authority's cash is placed on fixed deposit to earn additional interest.

Prudential Indicators

In order to control and monitor PCC's treasury management functions, a number of prudential indicators are determined against which performance may be measured. The indicators for 2017/18 are shown in the table below alongside the current actual and none of the indicators have been breached over the period.

	2017-18 PIs	**Actual at 30.9.17**
Adoption of the CIPFA Code of Practice for Treasury Management	Adopted	Adopted
Authorised limit for external debt	£m	£m
A prudent estimate of total external debt, which does not reflect the worst case scenario, but allows sufficient headroom for unusual cash movements		
Borrowing	53.000	17.054
Other long-term liabilities	1.000	-

Total	54.000	17.054
Operational boundary for external debt		
A prudent estimate of debt, but no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of the Authority's current plans		
Borrowing	45.000	17.054
Other long-term liabilities	0.500	-
Total	45.500	17.054

	2017-18 PIs	**Actual at 30.9.17**
Upper limit for fixed interest rate exposure		
Borrowing	100%	100%
Investments	100%	13%
Upper limit for variable rate exposure		
Borrowing	75%	0%
Investments	100%	87%
Upper limit for total principal sums invested for over 364 days (per maturity date)	50%	Nil
Maturity structure of debt from 31.3.17	**Upper/ Lower Limits**	**Actual**
Under 12 months	50% / nil	0%
12 months and within 24 months	50% / nil	13%
24 months and within 5 years	50% / nil	12%
5 years and within 10 years	80% / nil	28%
10 years and above	90% / 25%	47%

Regulatory Updates

The first half year saw work being undertaken on two areas namely moves towards the implementation of MiFID II and CIPFA consulting on changes to the Prudential and Treasury Management Codes.

MiFID II

Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. But from 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the

Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

CIPFA Consultation on Prudential and Treasury Management Codes

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to the PCC which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet

Business Risk Implications

The Treasury Management strategy is designed to minimise the PCC for Lancashire's financial risk associated with investment decisions, whilst maximising the return on any investments made. As such the adoption of the CIPFA's Code of Practice on Treasury Management and the monitoring arrangements in place ensure that any risks faced by PCC are managed.

However, it must be acknowledged that there will always be a balance between risk and return and hence the strategy does not completely eliminate the risk of any further default on investments in the future.

2. Links to the Police and Crime Plan

Regular monitoring of the Commissioner's Treasury management activity enables effective financial planning and control. This is essential to ensure the delivery of operational policing in Lancashire and the delivery of the Commissioner's statutory responsibilities.

3. Consultations

None

4. Implications:

a. Legal

There are no legal comments associated with this paper.

b. Financial

The financial implications are contained in the report

c. Equality considerations

There are no Equality comments associated with this paper.

5 Risk Management

6. Background Papers

CIPFA Treasury Management Code of Practice (2011)
PCC for Lancashire Treasury Management Strategy 2017/18

7. Public access to information

Information in this form is subject to the Freedom of Information Act 2000 and other legislation.

Part 1 of this form will be made available on the PCC website within 3 working days of approval. Any facts/advice/recommendations that should not be made available on request should not be included in Part 1 but instead on the separate Part 2 form.

Officer declaration	Date
As above **LEGAL IMPLICATIONS**	
As above **FINANCIAL IMPLICATIONS**	

As above **EQUALITIES IMPLICATIONS**	
As above **CONSULTATION**	

Chief Executive Officer (Monitoring Officer)

I have been informed about the proposal and confirm that financial, legal and equalities advice has been taken into account in the preparation of this report. I am satisfied that this is an appropriate request to be submitted to the Police and Crime Commissioner for Lancashire.

Signature...Date....20 . 11-2017 ....