POLICE AND CRIME COMMISSIONER FOR HAMPSHIRE AND HAMPSHIRE CONSTABULARY

JOINT AUDIT COMMITTEE – 21 September 2015

Treasury Management Mid-year Report 2015/16

REPORT OF THE CHIEF FINANCE OFFICER OF THE OFFICE OF THE POLICE AND CRIME COMMISSIONER

1. Purpose

1.1. The Treasury Management Strategy for 2015/16 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2. The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that the Office of the Police and Crime Commissioner (OPCC) is embracing best practice in accordance with CIPFA's recommendations.

1.3. Treasury management is defined as: "The management of investments and cash flows, 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. Recommendation

2.1. It is recommended that the Joint Audit Committee considers the report and makes observations as appropriate.

3. Economic background

3.1. The following Section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

3.2. Growth - Positive growth in the UK economy has continued with output growing at a preliminary estimate of 2.6% year-on-year in Q2 2015, which was in line with the market's expectations. The largest contribution to growth came from services - increasing by 0.7% and contributing 0.5% to overall growth.

3.3. The latest figures released by the Office for National Statistics for June 2015 show a broadly stable UK labour market, with marginal movements in the number of employed (down to 73.4% from 73.5%) and the number of unemployed (up to 5.8% from 5.7%). Wage growth was 2.8% excluding bonuses over the year to June 2015.

3.4. The Consumer Prices Index (CPI) rose by 0.1% in the year to July 2015, up from 0.0% in June. This was slightly above market expectations, which had predicted inflation remaining at 0.0%. As set out in the Governor of the Bank of England's letter to the Chancellor, around three quarters of the weakness in headline inflation relative to the 2% target reflects unusually low contributions from energy, food and other imported goods prices. The remaining part of the undershoot is judged to reflect relatively weak domestic cost growth, given a continuing, but declining, drag from spare capacity in the labour market.

3.5. UK Monetary Policy: At its meeting ending on 5 August 2015, the Monetary Policy Committee (MPC) voted by a majority of 8-1 to maintain Bank Rate at 0.5%. Interestingly this is the first meeting in a number of months that the vote to hold rates at 0.5% has not been unanimous, perhaps indicating that the first rise in interest rates is approaching.

3.6. The MPC has previously emphasised that when the Bank Rate does begin to rise, it is expected to do so only gradually and to remain below average historical levels for some time to come. The treasury management advisors to the OPCC, Arlingclose, now estimate the first rise in interest rates will be in the second quarter of 2016 still later than many economic commentators. Their expectation is that the appropriate level for Bank Rate for the post-crisis UK economy will be lower than the previous norm, between 2.0 and 3.0%.

4. Investments

4.1. The OPCC has an investment portfolio consisting of reserves and short-term cash flows. The OPCC is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy.

4.2. The transposition of European Union directives into UK legislation now places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors (including Police and Crime Commissioners) through potential bail-in of unsecured bank deposits.

4.3. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the OPCC's aim to further diversify into more secure and/or higher yielding asset classes during 2015/16. The majority of the OPCC's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification into securities with underlying capital and investments with organisations which are not subject to bail-in represents a substantial change in strategy this year.

4.4. The OPCC's investment holding was £105.7m at 25 August 2015, which is £7.7m (7.8%) higher than the same time last year, and was placed with the following counterparties:

Investments as at 25 August 2015

Duration to maturity	Overnight £m	<1 year £m	>1 year £m	Total £m
Subject to bail-in risk				
Bank call accounts	9.8			9.8
Bank notice accounts		6.0		6.0
Bank certificates of deposit*		35.0		35.0
	9.8	41.0	0.0	50.8
Exempt from bail-in risk				
Covered floating rate notes		4.0	2.0	6.0
Floating rate notes		1.8		1.8
Covered corporate bonds			3.5	3.5
Corporate bonds		8.4		8.4
Money market funds	21.8			21.8
Local authorities		4.0	8.4	12.4
Pooled property fund			1.0	1.0
	21.8	18.2	14.9	54.9
Total	31.6	59.2	14.9	105.7

*Certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market

4.5. Security of capital has remained the OPCC's main investment objective. This has been maintained by following the OPCC's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

4.6. Counterparty credit quality was assessed and monitored with reference to credit ratings (the OPCC's minimum long-term counterparty rating for institutions defined as having 'high credit quality' is BBB- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.7. The level of cash balances is expected to fall between now and the end of the financial year when they are forecast to be around £65m. The major reason for the uneven profile of the OPCC's cash balance is the Police Pension Grant of £41m, which is paid by Central Government in a single instalment each July, and then paid out gradually by the OPCC throughout the year.

4.8. The average interest rate earned on these investments at 25 August 2015 was 0.75%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money market rates.

4.9. The Guidance on Local Government Investments in England gives priority to security and liquidity and the OPCC's aim is to achieve a yield commensurate with these principles. This has been maintained by following the OPCC's counterparty policy as set out in its Treasury Management Strategy for 2015/16.

5. Borrowing

5.1. The OPCC's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2015 was £46.3m. Affordability and the "cost of carry" remained important influences on the OPCC's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

5.2. For the OPCC the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place in the five months to August 2015, or is planned for the remainder of the financial year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

5.3. As at 25 August 2015 the OPCC had a total of £35.3m of long term loans, made up of a number of Public Works Loan Board (PWLB) loans at a weighted average fixed interest rate of 4.09%, and average outstanding term remaining of 16.3 years. This average rate compares favourably against historic interest rates and the OPCC's debt portfolio represents good mitigation against the long-term risk of exposure to interest rate fluctuations, which could increase the cost of borrowing.

5.4. The premia that applies to the premature repayment of the OPCC's PWLB loans is still relatively expensive for the loans in the portfolio and therefore unattractive for debt rescheduling. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for the OPCC to reduce or restructure its debt portfolio.

6. Compliance with Prudential Indicators

6.1. During the first five months of 2015/16, the OPCC operated within the treasury management indicators set out in the Treasury Management Strategy.

Authorised limit for external debt

6.2. CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by the Police and Crime Commissioner on 31 March 2015 set an authorised limit for external debt of £95m.

6.3. This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the OPCC's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.

6.4. During the period to 25 August 2015 borrowing remained well within the authorised limit of £95m and no new long term borrowing has been taken out. There has been no temporary borrowing, so the maximum total external debt in the period has remained at the total long-term borrowing amount of £36.0m at the beginning of the financial year.

Operational boundary for external debt

6.5. The OPCC has set an operational boundary for external debt reflecting the more likely scenario and consistent with the OPCC's capital plans and Treasury Management Strategy. Temporary breaches of the 2015/16 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The PCC approved an operational boundary for 2015/16 of £85m.

6.6. As outlined above the OPCC's maximum total external debt of £36.0m in the period from April to August 2015 was within the operational boundary.

Upper limit on fixed and variable interest rate exposure

6.7. The OPCC has to set an upper limit on its fixed and variable interest rate exposure for both total investments and total external debt. The PCC approved the following limits, none of which have been exceeded as follows:

	Limit	Max. to 25 Aug 2015
Upper limit on fixed interest rate investment exposure	£29m	£12m
Upper limit on variable interest rate investment exposure	£130m	£106m
Upper limit on fixed interest rate borrowing exposure	£95m	£36m
Upper limit on variable interest rate borrowing exposure	£95m	£0m

6.8. The limit for borrowing rate exposure has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. All of the OPCC's long-term debt portfolio is currently made up of fixed interest loans.

6.9. The upper limit for exposure for investments rates is based on an extreme case for the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less than one year) if necessary.

Upper and lower percentage limits on the maturity structure of long-term fixed-rate borrowing outstanding in 2015/16

6.10. The Code also requires the OPCC to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2015/16. The following table shows the limits approved by the PCC. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

	Upper	**Lower**	**Actual**
Under 12 months	50%	0%	5%
12 months and within 24 months	50%	0%	3%
24 months and within 5 years	50%	0%	7%
5 years and within 10 years	75%	0%	4%
10 years and within 20 years	75%	0%	50%
20 years and above	100%	0%	31%

Upper limits on investments with maturities longer than one year

6.11. For 2015/16 the OPCC restricted investments for periods of over a year to a maximum of £29m. At 25 August 2015 the OPCC had £14.9m of investments with over 364 days to their maturity.

Name *– Andrew Boutflower*

Position *– Deputy Investments and Borrowing Manager*

For further information please contact Andrew Boutflower, on 01962 847407 or e-mail: andrew.boutflower@hants.gov.uk