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POLICE AND CRIME COMMISSIONER FOR HAMPSHIRE AND HAMPSHIRE CONSTABULARY

JOINT AUDIT COMMITTEE – 22 June 2017

Annual Treasury Outturn Report 2016/17

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

1. Purpose

1.1. The Office of the Police & Crime Commissioner for Hampshire (OPCC) adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

1.2. The purpose of this report is, therefore, to consider:

- The borrowing activity in 2016/17
- The investment activity in 2016/17
- Compliance with Prudential Indicators set in 2016/17
- Compliance with Treasury Management Indicators set in 2016/17

2. Recommendation

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

3. Introduction

3.1. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

3.2. This annual report sets out the performance of the treasury management function during 2016/17, to include the effects of the decisions taken and the transactions executed in the past year.

3.3. Overall responsibility for treasury management remains with the OPCC. No treasury management activity is without risk; the effective identification and management of risk are integral to the OPCC's treasury management objectives.

3.4. All treasury activity has complied with the OPCC's Treasury Management Strategy and Investment Strategy for 2016/17, and all relevant statute, guidance and accounting standards. In addition the OPCC's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

3.5. The OPCC has complied with all of the prudential indicators set in its Treasury Management Strategy; these are detailed fully in Appendix 1.

4. External Context

4.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2016/17.

Economic Background

4.2. Politically, 2016/17 was an extraordinary 12 month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA.

4.3. UK inflation has been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year on year in April 2016 to 2.3% year on year in March 2017.

4.4. In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases.

4.5. Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016, and in February the unemployment rate dropped to 4.7%, its lowest level in 11 years.

Financial Markets

4.6. After recovering from an initial sharp drop in Quarter 2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March. Overnight money market rates have remained low since Bank Rate was cut in August.

Credit Background

4.7. Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

5. Local Context

5.1. At 31/03/2017 the OPCC's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £42.4m, while usable reserves and working capital which are the underlying resources available for investment were £73.0m (principal invested plus gains on investments with a variable net asset value).

5.2. At 31/03/2017, the OPCC had £33.0m of borrowing and £72.5m of principal invested. The OPCC's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

5.3. The OPCC has an increasing CFR over the forecast period due to the capital programme. Usable reserves are planned to reduce as they are used to fund the capital programme. This will result in a reduction in overall investment balances, but not to the extent that the OPCC cannot continue its policy of internal borrowing, if this continues to be advantageous.

6. Borrowing Strategy

6.1. At 31/03/2017 the OPCC held £33.0m of loans, (a reduction of £1.2m due to repayments since 31/03/2016) as part of its strategy for funding previous years' capital programmes.

6.2. The OPCC's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the OPCC's long-term plans change being a secondary objective.

6.3. 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. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the OPCC determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing.

6.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the OPCC with the monitoring of internal and external borrowing.

Table 1: Borrowing Activity in 2016/17

	Balance on 01/04/2016 £m	Net New Borrowing £m	Balance on 31/03/2017 £m
CFR	51.4		42.4
Short Term Borrowing[1]	1.2	-	1.2
Long Term Borrowing	33.0	(1.2)	31.8
TOTAL BORROWING	**34.2**	**(1.2)**	**33.0**
Other Long Term Liabilities	0.8	(0.2)	0.6
TOTAL EXTERNAL DEBT	**35.0**	**(1.4)**	**33.6**
Increase/ (Decrease) in Borrowing £m			(1.2)

6.5. During 2016/17 the OPCC repaid £1.2m of maturing PWLB debt, and did not replace this borrowing. This will reduce the future cost of interest payments on the OPCC's external debt.

Debt Rescheduling

6.6. The premium charged for early repayment of PWLB debt remained relatively expensive for the loans in the OPCC's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence. However, consideration continues to be given to any advantageous opportunity for the OPCC to reduce or restructure its debt portfolio.

7. Investment Activity

7.1. The combined effect of the EU Bank Recovery and Resolution Directive and the UK's Deposit Guarantee Scheme Directive is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

7.2. The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities, means

[1] Loans with maturities less than 1 year.

that the risks of making unsecured deposits rose relative to other investment options. Since 2014/15 the OPCC therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits.

7.3. The OPCC has held invested funds representing income received in advance of expenditure plus balances and reserves held. During 2016/17 the OPCC's investment balances have ranged between £57.1 and £116.5 million.

Table 2: Investment Activity in 2016/17

Investments	Balance on 01/04/2016 £m	Balance on 31/03/2017 £m	Average Rate/Yield on 31/03/2017 %	Average Life on 31/03/2017 years
Short term investments				
- Banks and Building Societies				
- Unsecured	20.8	14.6	0.57	0.17
- Secured	7.0	4.0	0.60	0.53
- Money Market Funds	14.8	12.4	0.26	0.00
- Local Authorities	9.6	16.5	0.85	0.33
- Corporate Bonds	-	1.0	0.37	0.19
- Government Bonds	1.0	-	-	-
	53.2	**48.5**	**0.59**	**0.21**
Long term investments				
- Banks and Building Societies				
- Secured	9.0	17.0	0.71	1.78
- Local Authorities	7.0	2.0	1.04	1.06
	16.0	**19.0**	**0.74**	**1.70**
High yield investments				
- Pooled Property Funds	3.0	3.0	4.58	n/a
- Pooled Equity Funds	-	2.0	3.04	n/a
	3.0	**5.0**	**3.96**	**n/a**
TOTAL INVESTMENTS	**72.2**	**72.5**	**0.86**	**0.63**
Increase/ (Decrease) in Investments £m		0.3		

7.4. Both the CIPFA Code and the government guidance require the OPCC 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 OPCC'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 unsuitably low investment income.

7.5. Over the year the OPCC reduced its exposure to unsecured bank and building society investments by increasing its exposures to secured banks and building society investments and local authorities. The OPCC has also invested in further high yield investments by investing in pooled equity funds.

7.6. The pooled property and equity fund investments allow the OPCC to diversify into asset classes other than cash without the need to own and manage underlying investments. The funds are operated on a variable net asset value (VNAV) basis offering diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short term. The OPCC's pooled fund investments are in the funds' distributing share classes which pay out the income generated.

7.7. Although money can be redeemed from pooled funds at short notice, the OPCC's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the OPCC's investment objectives are monitored regularly and discussed with Arlingclose.

7.8. 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 2016/17.

7.9. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

7.10. The OPCC will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

7.11. The OPCC maintained a sufficient level of liquidity through the use of call accounts and money market funds. The OPCC sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate has been maintained at 0.25% since August 2016 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

7.12. The average cash balances were £89.1m during the year and interest earned for the year was £0.783m, giving a yield of 0.88%.

8. Compliance with Prudential Indicators

8.1. The OPCC confirms compliance with its Prudential Indicators for 2016/17, which were set in March 2016 as part of the OPCC's Treasury Management Strategy Statement.

9. Treasury Management Indicators

9.1. The OPCC measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

9.2. This indicator is set to control the OPCC's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 3 – Interest Rate Exposures

	Approved limits for 2016/17	Maximum during 2016/17	Compliance with limits:
Upper limit on fixed interest rate investment exposure	£33m	£10m	Yes
Upper limit on variable interest rate investment exposure	£130m	£108m	Yes
Upper limit on fixed interest rate borrowing exposure	£85m	£34m	Yes
Upper limit on variable interest rate borrowing exposure	£85m	£3m	Yes

9.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

9.4. This indicator is set to control the OPCC's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 4 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	3.7%
12 months and within 24 months	50%	0%	2.6%
24 months and within 5 years	50%	0%	3.8%
5 years and within 10 years	75%	0%	2.1%
10 years and within 20 years	100%	0%	75.7%
20 years and above	100%	0%	12.1%

Principal Sums Invested for Periods Longer than 364 days

9.5. The purpose of this indicator is to control the OPCC's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 5 – Principal Sums Invested for Periods Longer than 364 days

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£33m	£24m	£23m
2016/17 Maximum	£26m		

Appendix 1

Prudential Indicators 2016/17

The Local Government Act 2003 requires the OPCC to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the OPCC has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure

The OPCC's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme report.

Capital Expenditure and Financing	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
Total Expenditure	**38.4**	**46.1**	**28.6**	**33.1**	**7.8**
Capital Receipts	36.8	38.9	**30.2**	10.2	5.0
Government Grants	3.5	2.6	**2.8**	1.2	1.2
Revenue Contributions	9.2	13.7	**3.2**	1.9	1.2
Total Financing	**49.5**	**55.2**	**36.2**	**13.3**	**7.4**
Prudential Borrowing	(11.1)	(9.1)	**(7.6)**	19.8	0.4
Total Funding	**(11.1)**	**(9.1)**	**(7.6)**	**19.8**	**0.4**
Total Financing and Funding	**38.4**	**46.1**	**28.6**	**33.1**	**7.8**

Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the OPCC's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31.03.17 Approved £m**	**31.03.17 Revised £m**	**31.03.17 Actual £m**	**31.03.18 Estimate £m**	**31.03.19 Estimate £m**
General Fund	46.4	40.9	**42.4**	59.5	58.2

The CFR is forecast to rise by £15.8m over the next two years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the OPCC should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	**31.03.17 Approved £m**	**31.03.17 Revised £m**	**31.03.17 Actual £m**	**31.03.18 Estimate £m**	**31.03.19 Estimate £m**
Borrowing	33.0	33.0	**33.0**	31.8	31.0
Total Debt	**33.0**	**33.0**	**33.0**	**31.8**	**31.0**

Total debt is expected to remain below the CFR during the forecast period.

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

Operational Boundary for External Debt

The operational boundary is based on the OPCC's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	**2016/17 Approved £m**	**2016/17 Revised £m**	**2016/17 Actual £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**
Borrowing	60	55	**33**	73	72
Other long-term liabilities	5	5	**1**	5	5
Total Debt	**65**	**60**	**34**	**78**	**77**

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Appendix 1

Authorised Limit for External Debt

The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the OPCC can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2016/17 Approved £m**	**2016/17 Revised £m**	**2016/17 Actual £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**
Borrowing	73	67	**33**	86	84
Other long-term liabilities	5	5	**1**	5	5
Total Debt	**78**	**72**	**34**	**91**	**89**

Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2016/17 Approved %**	**2016/17 Revised %**	**2016/17 Actual %**	**2017/18 Estimate %**	**2018/19 Estimate %**
General Fund	0.86	0.77	**0.67**	0.76	1.01

Adoption of the CIPFA Treasury Management Code

The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2013.