



## AGENDA NO: 9a

### INDEPENDENT AUDIT COMMITTEE – 17 December 2019

### 2019/20 TREASURY MANAGEMENT MID-YEAR REPORT

### REPORT BY JULIE STRANGE, CHIEF FINANCE OFFICER, DORSET OPCC

### PURPOSE OF THE REPORT

*The purpose of this report is to present the 2019/20 treasury management mid-year report for Dorset, for comment.*

#### 1. Introduction

- 1.1. The Treasury Management Strategy for 2019/20 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 a report on Treasury Management activities at least twice a year; a mid-year, and a year-end (outturn) report, and both of these are reported to the Independent Audit Committee. This report sets out the performance of the treasury management function for the period from 1 April to 30 September 2019.
- 1.3. Treasury management is defined as:

*“The management of the PCC’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.”*
- 1.4. Operational treasury management activity is undertaken by the Alliance finance function, supported by the treasury advisors Arlingclose Limited, under the direction of the Chief Finance Officer (Treasurer), and in accordance with the strategy and practices approved by the PCC.

- 1.5. The 2018/19 outturn report highlighted that the combination of lower levels of reserves and lower working capital (mainly as a consequence of higher government debtors), together with the normal fluctuations in cash flows meant that the liquidity indicator would have been reviewed in 2019/20. This review has been completed and a proposed revision to the 2019/20 liquidity indicator from £9m to £6m was recommended and approved by the Resource Control Board in July 2019.
- 1.6. All treasury activity in the year to September complied with the PCC's Treasury Management Strategy, Investment Strategy and revised indicators as well as all relevant statute, guidance and accounting standards.

## **2. External Context**

- 2.1. Quarter 2 GDP contracted by 0.2% following the 0.5% gain in quarter 1 which was distorted by stock piling ahead of Brexit. UK Consumer Price Inflation fell to 1.7% year/year in August from 2.0% in July, and the Bank Base Rate remained at 0.75%. A fuller explanation of the external context, as provided by the Treasury Management Advisors, Arlingclose Limited, is provided in Appendix 4.

## **3. Investment Activity**

- 3.1. At 30 September 2019 the PCC short term investments and cash equivalents were £21m. In the year to September balances ranged between £0.1m and £32m. In April, May and June we borrowed £2.7m, £6m and £6.5m respectively to overcome a shortage in cash. The interest incurred amounted to £2.4k. The lenders were three Local Authorities.
- 3.2. The period-end investment position and the year-to-date change is shown at Appendix 1 Table 2.
- 3.3. Both the CIPFA Code and government guidance require funds to be invested prudently, with regard to the security and liquidity of investments before seeking the highest rate of return, or yield. The 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.
- 3.4. Investments are reviewed quarterly and benchmarked against other similar organisations by Arlingclose Ltd. The outturn benchmarking is provided at Appendix 1 - Table 3. Compared with the average of Police and Fire Authorities Dorset balances are relatively lower, the security rating of funds is relatively higher and consequently the yield is slightly lower. We continue to focus on how to improve this position within the constraints of the volatility of the cash flows.
- 3.5. One element of the Treasury Management Strategy that has been considered is the maximum amounts that can be invested in individual investments. The 2019/20 counterparty limits were based on an estimated year end cashflow position of £10m, enabling unsecured bank deposits of up to £500k and secured deposits of up to

£1m. However, for a significant period of the first six months, cashflow has been in excess of £20m following receipt of the pensions grant in July. This presents real practical difficulties for the Technical Team in trying to identify up to 40 different counterparties to invest with, who will accept deposits as low as £500k. This simply isn't possible therefore large quantities of cashflow are invested with the Government's Debt Management Office which earns interest at less than the Bank of England Base Rate. In order to address this issue a paper has been presented to the Resource Control Board proposing the application of different limits when cashflow is in excess of £10m. This proposal was approved. This approach will also feature in the draft 2020/21 Treasury Management Strategy.

#### **4. Borrowing Activity**

- 4.1. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment.
- 4.2. At 30 September Dorset's underlying need to borrow for capital purposes / CFR was £28.9m, in line with the estimate in the Treasury Management Strategy (see Appendix 3 Table 10).
- 4.3. Most of the CFR at the year-end relates to debt in respect of two schemes under the government's Private Finance Initiatives (PFI). The first was for the replacement of the Western Division HQ and certain section stations. Occupation of the facilities and payments commenced in 2001 and will end in 2032. The closing balance at 30 September 2019 was £5.115m. The second relates to the provision of a new facility at Poole as part of a joint PFI between Dorset Police and Dorset Fire and Rescue Services. Occupation was in 2009 and payments will end in 2035. The closing balance at 30 September 2019 was £21.862m. Government grants are received annually towards the costs of these schemes.

#### **5. Performance Report**

- 5.1. The financial performance of treasury management activities is measured both in terms of its impact on the revenue budget and its relationship to benchmark interest rates. The Arlingclose benchmarking is provided at Appendix 1 Table 3.
- 5.2. Interest receivable forecast for the year is £110k which is significantly higher than the original budget of £20k. This is mainly due to changes in the cash profiling of Transforming Forensics. The cash profile budget was based on receiving the Transforming Forensics Grant on a quarterly basis in arrears with spend scheduled monthly. This pattern of cashflow has not materialised. Instead, spending levels have been much lower than expected which has been mainly caused by delays in other organisations invoicing Dorset Police. The frequency of the grants has also changed from quarterly to monthly as agreed with the Home Office. With funds received in advance of spend and spend at a lower level the amount of available

cash has been relatively high. This has enabled the team to make a number of investments, increasing the level of interest received, which has also now been reflected in the forecast.

- 5.3. The average rate compared with credit risk has remained fairly constant since December 2018 with Dorset receiving higher returns with counterparties that are of a lower credit risk. The Arlingclose benchmarking is provided at Appendix 1 Table 3.

## **6. OTHER ISSUES**

- 6.1. The collapse of Icelandic banks in 2008 leaves an outstanding balance of £40k out of a claim totalling £2,035,104 in respect of a temporary loan of £2m to Heritable Bank Ltd (now in administration). The last Administrator's report advised that they propose to apply to the Court of Session for a further extension to the Administration for a period of one year. The key reason for the proposed application for an extension is to allow sufficient time for a final distribution to be made to creditors and for closure of the Administration.

**Lucinda Hines**

**Head of Technical Accounting**

**Julie Strange**

**Chief Finance Officer for Dorset OPCC**

### **Appendices**

Appendix 1 – Investments

Appendix 2 – Treasury Management Indicators

Appendix 3 – Prudential Indicators

Appendix 4 – Economic Update provided by Arlingclose Ltd

## INVESTMENTS

Appendix 1

Table 1: Investment Limits

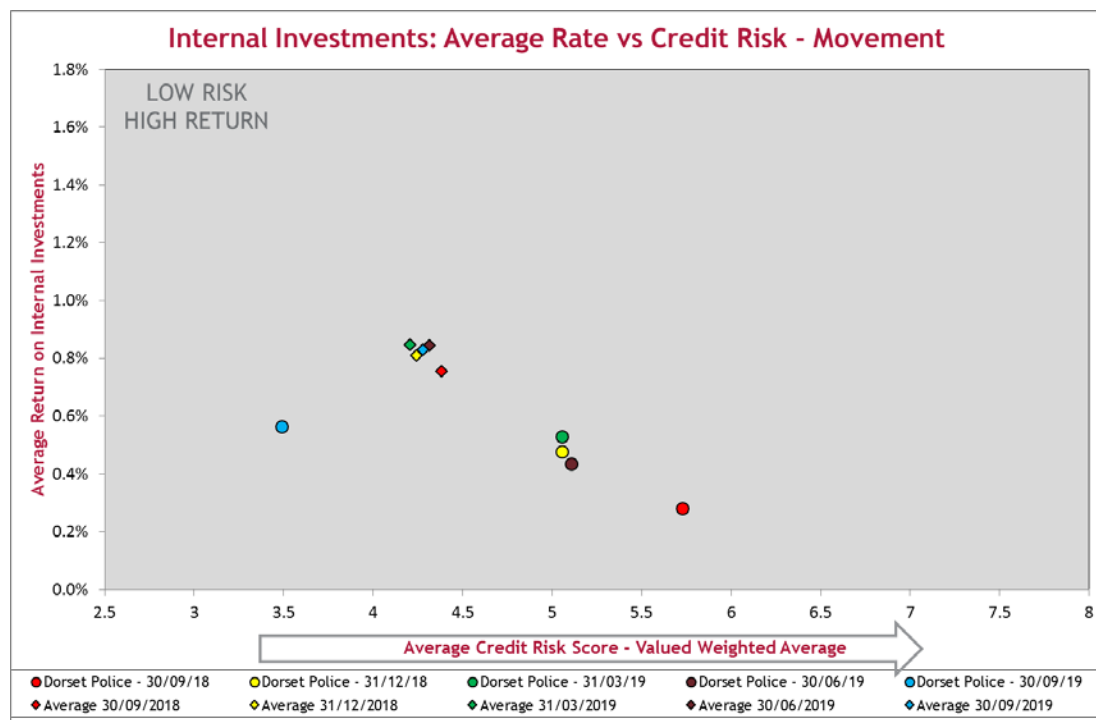
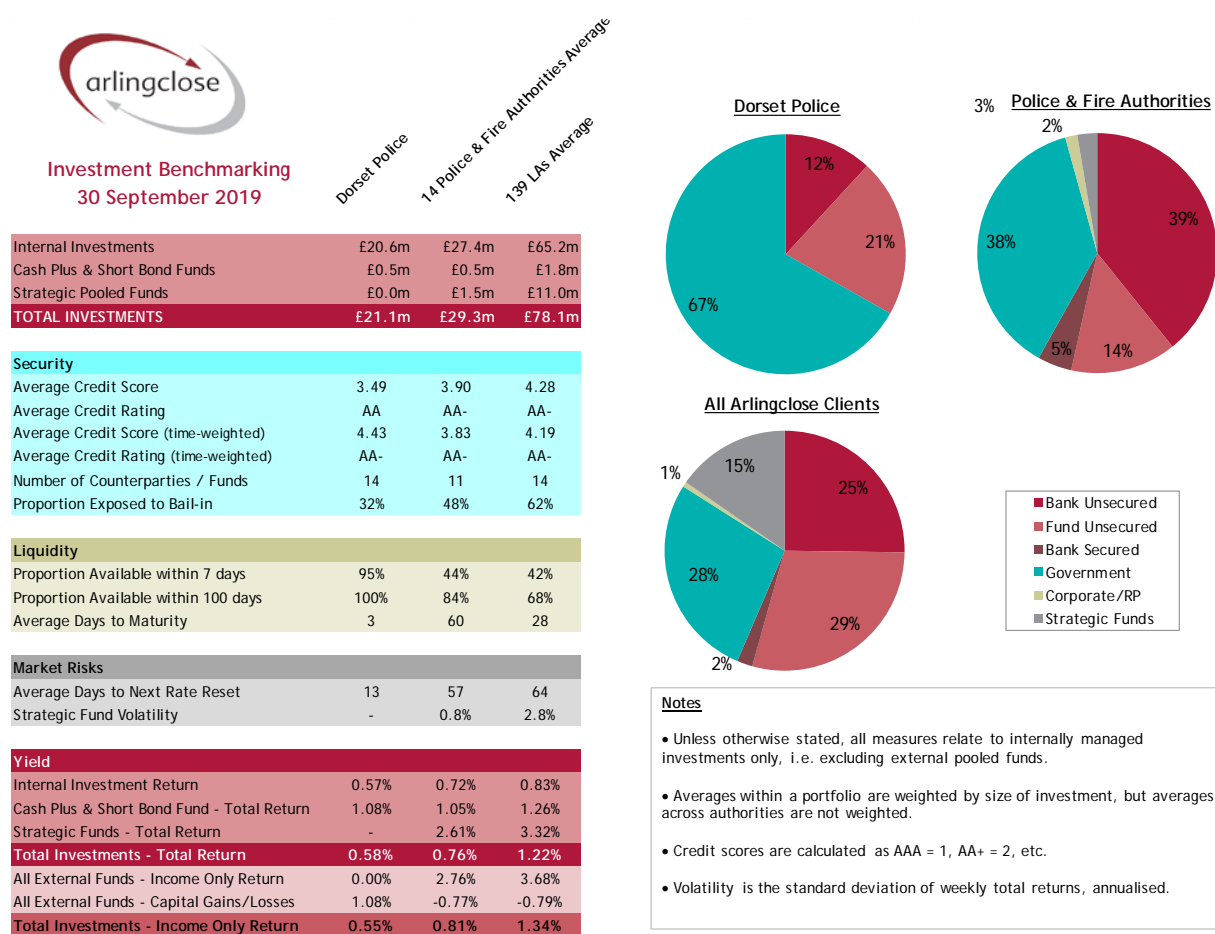
	<b>2019/20 Cash Limit</b>	<b>30.09.19 Actual</b>	<b>Complied?</b>
Any single organisation, except the UK Government	£1m each (£0.5m unsecured funds)	£0.5m unsecured and DMO £14.1m	Yes
Any group of organisations under the same ownership	£1m per Group (£0.5m unsecured funds)	£0	Yes
Any group of pooled funds under the same management	£1m per manager	£0	Yes
Negotiable instruments held in a broker's nominee account	£12m per Broker	£0	Yes
Limit per non-UK country	£1m per country	£0	Yes
Registered providers	£3m in Total	£0	Yes
Unsecured investments with building societies	£3m in Total	£0	Yes
Money Market Funds	£12m in Total	£5m	Yes
Bank Account	£1.25m	£1.07m	Yes

Table 2: Treasury Management Summary

	<b>31st March 2019</b>	<b>30th September 2019</b>	<b>Year on Year</b>
	<b>Actual Portfolio £'000</b>	<b>Actual Portfolio £'000</b>	<b>Change £'000</b>
<b>External Borrowing:</b>			
<b>Total External Borrowing</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Other Long-Term Liabilities:</b>			
Private Finance Initiative	(27,978)	(26,977)	(1,002)
Other long term liabilities	(1,086)	(1,026)	(60)
<b>Total Other Long-Term Liabilities</b>	<b>(29,064)</b>	<b>(28,003)</b>	<b>(1,061)</b>
<b>Total Gross External Debt</b>	<b>(29,064)</b>	<b>(28,003)</b>	<b>(1,061)</b>
<b>Treasury Investments:</b>			
Short-term investments	3,469	1,500	1,969
Cash and cash equivalents	2,052	19,672	(17,620)
<b>Total Treasury Investments</b>	<b>5,521</b>	<b>21,172</b>	<b>(15,652)</b>
<b>Net Debt</b>	<b>(23,543)</b>	<b>(6,830)</b>	<b>(16,713)</b>

INVESTMENTS

Table 3: Benchmarking Information



**TREASURY MANAGEMENT INDICATORS**

Appendix 2

Exposures to treasury management risks are measured using the following indicators.

**Table 4: Security**

This is a voluntary measure of exposure to credit risk which monitors the weighted average credit rating of the investment portfolio.

	2019/20	30.09.2019	Complied?
	Target	Actual	
Portfolio average credit rating	A+	AA	Yes

**Table 5: Liquidity**

This is a voluntary measure of exposure to liquidity risk which monitors the amount of cash available to meet unexpected variation in the cash flow:

	2019/20	2019/20	30.09.2019	Complied?
	Target	Revised Target	Actual	
Minimum limit at less than 31 days duration	£9m	£6m	£20.1m	Yes
Minimum limit overnight	£3m	£3m	£19.6m	Yes

**Table 6: Interest Rate Exposures**

This indicator is set to control the exposure to interest rate risk.

	2019/20	30.09.2019	Complied?
	Limit	Actual	
Upper limit on 1 year revenue impact of a 1% rise in interest rates	£60k	(£26k)	Yes
Upper limit on 1 year revenue impact of a 1% fall in interest rates	£60k	£26k	Yes

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate. The calculation to establish the actual figure is based on the sum of the impact on each loan minus the sum of the impact on each investment. There was no external borrowing as at 30 September, only investments.

**TREASURY MANAGEMENT INDICATORS**

Appendix 2

**Table 7: Maturity Structure of Borrowing**

This indicator is set to control the PCC's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	2019/20		30.09.2019	Complied?
	Upper Limit	Lower Limit	Actual	
Under 12 months	10%	0%	0%	Yes
12 months and within 24 months	15%	0%	0%	Yes
24 months and within 5 years	25%	0%	0%	Yes
5 years and within 10 years	40%	0%	0%	Yes
10 years and above	100%	60%	100%	Yes

**Table 8: Principal Sums Invested for Periods Longer than 365 days**

The purpose of this indicator is to control the exposure to the risk of incurring losses by seeking early repayment of investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2019/20
Limit on principal invested beyond year end	£1m
Actual principal invested beyond year end	£0m
<b>Complied?</b>	Yes



**PRUDENTIAL INDICATORS**

Appendix 3

**Table 9: Debt Limits**

	<b>2019/20</b>	<b>30.09.2019</b>	<b>Operational Boundary</b>	<b>Authorised Limit</b>
	<b>Estimate</b>	<b>Actual</b>		
	<b>£'000</b>	<b>£'000</b>		
PFI liabilities	25,975	25,975	36,940	41,940
Other long term liabilities	966	966		
External Borrowing	0	0		
Internal Borrowing	1,804	1,958		
<b>Total Debt</b>	<b>28,746</b>	<b>28,898</b>		

**Table 10: Capital Financing Requirement (CFR)**

	<b>2019/20</b>	<b>30.09.2019</b>	<b>2019/20</b>
	<b>Estimate</b>	<b>Actual</b>	<b>Forecast</b>
	<b>£'000</b>	<b>£'000</b>	<b>£'000</b>
<b>Opening CFR</b>	<b>30,225</b>	<b>30,225</b>	<b>30,225</b>
Capital expenditure to be funded by borrowing	1,173	0	1,173
Less: Repayment of PFI	(2,004)	(1,002)	(2,004)
Less: Repayment of Other Long Term Liabilities	(120)	(60)	(120)
Less: Minimum Revenue Provision	(530)	(265)	(530)
<b>Closing CFR</b>	<b>28,745</b>	<b>28,898</b>	<b>28,745</b>

**ECONOMIC UPDATE provided by Arlingclose Ltd.**

Appendix 4

**External Context**

**Economic background:** UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31<sup>st</sup> October regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1<sup>st</sup> November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31<sup>st</sup> October.

**Financial markets:** After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%.

**ECONOMIC UPDATE provided by Arlingclose Ltd.**

Appendix 4

1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

**Credit background:** Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.