AGENDA NO: 12a

INDEPENDENT AUDIT COMMITTEE - 23 JULY 2019

DEVON AND CORNWALL - TREASURY MANAGEMENT OUTTURN 2018/19

REPORT BY NICOLA ALLEN

PURPOSE OF THE REPORT

The purpose of this report is to present the 2018/19 treasury management outturn for Devon and Cornwall, for comment prior to approval by the PCC.

1.0 INTRODUCTION

1.1 The Treasury Management Strategy for 2018/19 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 also reported to the Independent Audit Committee. Monitoring reports for Quarter 1 (April – June) and Quarter 3 (April to December) are reported to Force Resources Board. This report sets out the performance of the treasury management function for the period from 1 April to 31 March 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 In the year to March all treasury activity complied with the PCC's Treasury Management Strategy, Investment Strategy and revised indicators as well as all relevant statute, guidance and accounting standards **except for** the bank account cash limit. The balance was £2.465m which is £0.215m more than the cash limit. This breach was due to a capital receipt of £430k being received on the 31 March 2019 when it was scheduled to come in early April. The receipt was received late in the day and after the money market cut off times.

2.0 EXTERNAL CONTEXT

2.1 Annual GDP growth is at 1.4%; year-on-year CPI to February was 1.9%, 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.

3.0 INVESTMENT ACTIVITY

3.1 At 31 March 2019 Devon and Cornwall had short term investments and cash equivalents of £24m. In the year to March balances ranged between £4.7m and £73.7m. The period-end investment position and the year-to-date change is shown at Appendix 1 Table 2.

3.2 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.

3.3 Investments are reviewed quarterly and benchmarked against other similar organisations by Arlingclose Limited. The benchmarking for quarter 4 is provided at Appendix 1 - Table 3. Compared with the average of Police and Fire Authorities Devon and Cornwall balances are lower. One of the investments held has a capital and revenue element. The capital element incurred some losses which has caused the overall performance to decline. Arlingclose has advised us to leave the investment until the market picks up. Arlingclose has also advised that some of their other Police and Fire clients hold investments that are for a longer period of time and with property funds resulting in a higher average.

4.0 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 31 March 2019 the underlying need to borrow for capital purposes /CFR was £49.3m which is £4m more than forecast. This increase is not as a result of an increase in capital spend but a change to how the capital spend is funded. The decision was made to increase the use of internal borrowing and reduce the earmarked reserve contributions. This decision was established by reviewing the level of reserves held at 31 March 2019 and the level of future reserves. Internal borrowing can be converted to external borrowing creating some flexibility which would not be the case if reserves were used (see Appendix 3 Table 11).

4.3 All external borrowing has been arranged with PWLB. The next loan to mature will be in 2025.

5.0 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 for the year to March was £435k compared to a budgeted amount of £383k. The increase in income received and forecast is mainly due to fixed term investments that were in place between July and December and the duration of the cash plus fund.

5.3 The average rate vs credit risk has continued to improve since September 2018 with Devon and Cornwall receiving higher returns with counterparties that are of a lower credit risk. The Arlingclose benchmarking is provided at Appendix 1 Table 4

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Treasurer to the 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

	30.09.18 Actual	31.12.18 Actual	31.03.19 Actual	2018/19 Revised Cash Limit	Complied?
Any single organisation, except the UK Government	£6m unsecured	£6m unsecured	£6m unsecured	£12m each (£6m unsecured funds)	Yes
Any group of organisations under the same ownership	£8m (£6m unsecured funds and £2m secured funds)	£6m	£0m	£12m per Group (£6m unsecured funds)	Yes
Any group of pooled funds under the same management	£4m	£6m	£0m	£6m per manager	Yes
Negotiable instruments held in a broker's nominee account	£21.4m	£4m	£4m	**£24m per Broker**	Yes
Limit per non-UK country	£0m	£0m	£0m	£12m per country	Yes
Registered providers	£0m	£0m	£0m	£20m in Total	Yes
Unsecured investments with building societies	£5m	£0m	£0m	£12m in Total	Yes
Money Market Funds	£14.1m	£22m	£17.7m	£32m in Total	Yes
Bank Account	£1.7m	£2m	£2.465m	£2.25m	No

Table 2: Investment Position

	31.03.18 Actual Portfolio £'000	31.03.19 Actual Portfolio £'000	Movement £'000
External Borrowing	(30,277)	(30,277)	0
Finance Leases	(113)	(279)	166
Total Gross External Debt	**(30,390)**	**(30,555)**	**166**
Treasury Investments:			
Short Term Investments	33,707	10,203	23,504
Cash and Cash Equivalents	11,819	13,943	(2,124)
Total Treasury Investments	**45,526**	**24,146**	**21,380**
Net Investments/(Debt)	**15,136**	**(6,409)**	**21,546**

INVESTMENTS Appendix 1

Table 3: Benchmarking Information

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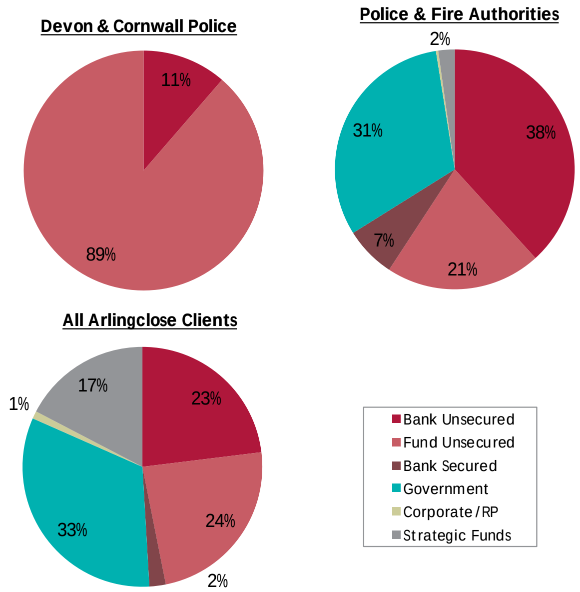
Investment Benchmarking
31 March 2019

	Devon & Cornwall Police	13 Police & Fire Authorities Average	144 LAs Average
Internal Investments	£7.7m	£16.1m	£51.0m
Cash Plus & Short Bond Funds	£9.9m	£1.1m	£1.6m
Strategic Pooled Funds	£0.0m	£0.4m	£10.0m
TOTAL INVESTMENTS	**£17.6m**	**£17.7m**	**£62.6m**
Security			
Average Credit Score	4.41	4.05	4.20
Average Credit Rating	AA-	AA-	AA-
Average Credit Score (time-weighted)	4.41	3.56	4.02
Average Credit Rating (time-weighted)	AA-	AA-	AA-
Number of Counterparties / Funds	4	8	13
Proportion Exposed to Bail-in	100%	60%	55%
Liquidity			
Proportion Available within 7 days	100%	58%	42%
Proportion Available within 100 days	100%	88%	65%
Average Days to Maturity	1	63	29
Market Risks			
Average Days to Next Rate Reset	40	51	53
Strategic Fund Volatility	-	0.7%	2.7%
Yield			
Internal Investment Return	0.71%	0.74%	0.85%
Cash Plus & Short Bond Fund - Total Return	0.74%	0.74%	0.91%
Strategic Funds - Total Return	-	6.98%	4.14%
Total Investments - Total Return	**0.73%**	**0.88%**	**1.43%**
All External Funds - Income Only Return	0.43%	2.67%	3.78%
All External Funds - Capital Gains/Losses	0.31%	1.19%	-0.12%
Total Investments - Income Only Return	**0.55%**	**0.82%**	**1.45%**



Notes

• Unless otherwise stated, all measures relate to internally managed investments only, i.e. excluding external pooled funds.

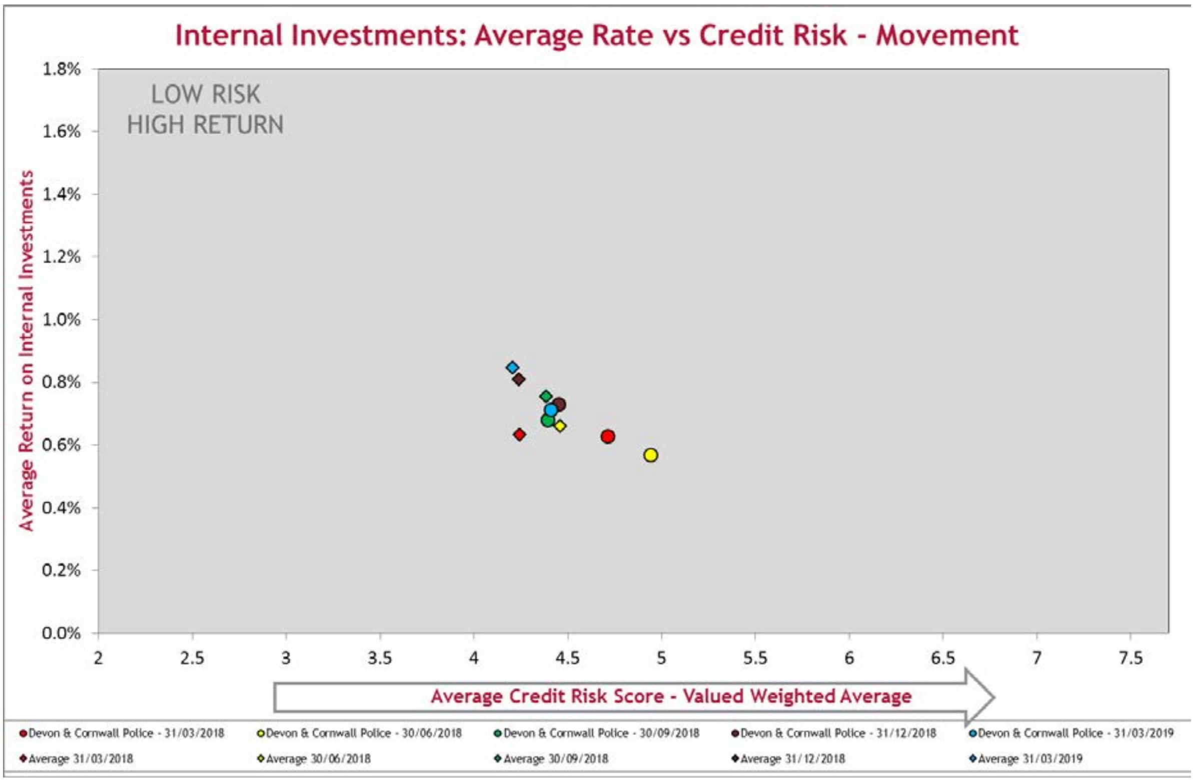
• Averages within a portfolio are weighted by size of investment, but averages across authorities are not weighted.

• Credit scores are calculated as AAA = 1, AA+ = 2, etc.

• Volatility is the standard deviation of weekly total returns, annualised.

INVESTMENTS Appendix 1

Table 4: Average Rate vs Credit Risk



TREASURY MANAGEMENT INDICATORS Appendix 2

Table 5: Security

The PCC has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio.

	2018/19 Target	**2018/19 Actual**	**Complied?**
Portfolio average credit rating	A+	AA-	Yes

Table 6: Interest Rate Exposures

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

	2018/19 TMS Limit	**2018/19 Actual**	**Complied?**
Upper limit on fixed interest rate exposure	100%	100%	Yes
Upper limit on variable interest rate exposure	30%	0%	Yes

Fixed rate 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.

Table 7: Liquidity

The PCC has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected variation in the cash flow:

	2018/19	**2018/19**	**Complied?**
	Target	**Actual**	
Minimum limit at less than 31 days duration	£12m	£17.7m	Yes
Minimum limit overnight	£4m	£11.7m	Yes

TREASURY MANAGEMENT INDICATORS Appendix 2

Table 8: 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:

	Upper Limit	Lower Limit	2018/19 Actual	Complied?
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%	7%	Yes
10 years and above	100%	60%	93%	Yes

Table 9: Principal Sums Invested for Periods Longer than 365 days

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

	2018/19
Limit on principal invested beyond year end	£20m
Actual principal invested beyond year end	£0m
Complied?	Yes

PRUDENTIAL INDICATORS Appendix 3

Table 10: Debt Limits

	2018/19 Estimate £'000	**2018/19 Actual £'000**	**2018/19 Operational Boundary £'000**	**2018/19 Authorised Limit £'000**	**Complied?**
External Borrowing	30,277	30,277	40,871	43,871	Yes
Other Long Term Liabilities	594	279			
Total external debt	**30,871**	**30,556**	**40,871**	**46,871**	

Table 11: Capital Financing Requirement (CFR)

	2018/19 Estimate £'000	**2018/19 Actual £'000**
Opening CFR	**39,781**	**38,915**
Capital expenditure to be funded by borrowing	7,852	11,880
Finance Lease	0	289
Less: Minimum Revenue Provision	(1,570)	(1,646)
Less: Finance Lease	(119)	(123)
Closing CFR	**45,944**	**49,314**

* Capital element for the MFD contract will be added once established.

ECONOMIC UPDATE provided by Arlingclose Ltd. Appendix 4

External Context

Economic background: After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day' has now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be showing signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE

100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

Credit background: Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc) transferred their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities.

In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.