AGENDA NO: 12b

INDEPENDENT AUDIT COMMITTEE - 23 JULY 2019

TREASURY MANAGEMENT OUTTURN 2018/19 (REVISED)

REPORT BY ALEXIS GARLICK

PURPOSE OF THE REPORT

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

1. 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. This report sets out the performance of the treasury management function for the period from 1 April 2018 to 31 March 2019 and fulfils the requirements of the Code which recommends a report on Treasury Management activities at least twice a year; a mid-year, and a year-end (outturn) report. In addition, monitoring reports for Quarter 1 (April – June) and Quarter 3 (April to December) are reported to the Resource Control Board.

1.3. Treasury management in the context of this report 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. With two exceptions, all treasury activity during 2018/19 fully complied with the PCC's Treasury Management Strategy, Investment Strategy and revised indicators as well as all relevant statute, guidance and accounting standards. The exceptions were in relation to the

Investment cash limit on the bank accounts (Table 1) and the Treasury Management Indicator for Liquidity (see Table 6). The Liquidity indicator is a voluntary measure of exposure to liquidity risk by monitoring the amount of cash available to meet an unexpected variation in the cash flow. This indicator was set at a minimum of £9m accessible at less than 31 days. This limit was revised down to £6m as at the 31 December 2018. The actual amount at 31 March 2019 was £5m.

1.6. It is now apparent 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 means that the liquidity indicator will have to be reduced for 2019/20. This is currently in the process of review.

2. External Context

2.1. Annual GDP growth 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. Investment Activity

3.1. At 31 March 2019 short term investments and cash equivalents were £5.5m. In the year to March balances ranged between £0.8m and £26m. A Treasury Management summary showing the investment and borrowing position and the year-to-date change is shown at Appendix 1 -Tables 2 and 3.

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 Ltd. The outturn benchmarking is provided at Appendix 1 - Table 4. 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.

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 31 March 2019 Dorset's underlying need to borrow for capital purposes / CFR was £30.225m, in line with the estimate in the Treasury Management Strategy (see Appendix 3 Table 11).

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 continue for 30 years. The closing balance at 31 March 2019 was £5.565m. 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 continue for 25 years. The closing balance at 31 March 2019 was £22.413m. Government grants are received annually towards the costs of these schemes.

5. <u>Performance Report</u>

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 4.

5.2. Interest receivable for the year to March was £100k which is lower than the original budget of £160k mainly because of lower average balances than estimated.

5.3. The average rate compared with credit risk has improved since December 2018 with Dorset receiving higher returns with counterparties that are of a lower credit risk. The Arlingclose benchmarking is provided at Appendix 4 Table 2.

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 latest Administrator's report, dated 19 March 2018, advises that a final distribution will not be made until the conclusion of claims from a subsidiary company in relation to intercompany loans. This is being progressed through the courts. There has been no update from the Administrator since March 2018.

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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 Cash Limit	2018/19 Revised Cash Limit	Complied?
Any single organisation, except the UK Government	£1.5m unsecured	£1.5m unsecured	£1.5m unsecured	£3m each (£1.5m unsecured funds)	£3m each (£1.5m unsecured funds)	Yes
Any group of organisations under the same ownership	£0	£0	£0	£3m per Group (£1.5m unsecured funds)	£3m per Group (£1.5m unsecured funds)	Yes
Any group of pooled funds under the same management	£0	£0	£0	£3m per manager	£3m per manager	Yes
Negotiable instruments held in a broker's nominee account	£4.5m	£0	£0	£6m per Broker	£12m per Broker	Yes
Limit per non-UK country	£0	£0	£0	£3m per country	£3m per country	Yes
Registered providers	£0	£0	£0	£6m in Total	£6m in Total	Yes
Unsecured investments with building societies	£1.5m	£0	£0	£3m in Total	£6m in Total	Yes
Money Market Funds	£4.8m	£4.3m	£3.47m	£6m in Total	£12m in Total	Yes
Bank Account	£2.23m	£0.53m	£1.42m	£2.25m	£1.25m	No

Table 2: Treasury Management Summary

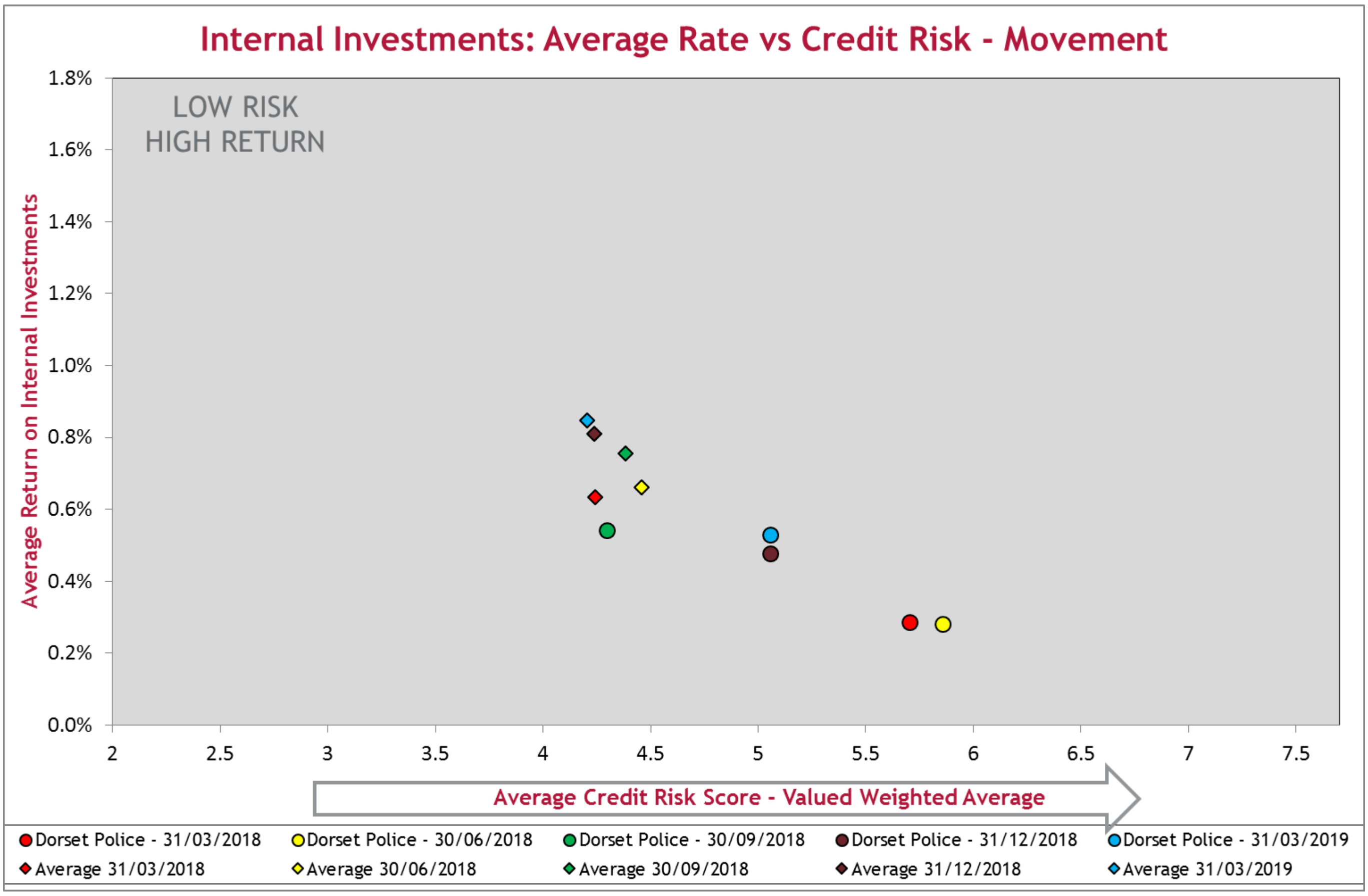
	31st March 2018 Actual Portfolio £'000	31st March 2019 Actual Portfolio £'000	Year on Year Change £'000
External Borrowing:			
Total External Borrowing	**0**	**0**	**0**
Other Long-Term Liabilities:			
Private Finance Initiative	(29,885)	(27,978)	(1,906)
Other long term liabilities	(1,205)	(1,086)	(120)
Total Other Long-Term Liabilities	**(31,090)**	**(29,064)**	**(2,026)**
Total Gross External Debt	**(31,090)**	**(29,064)**	**(2,026)**
Treasury Investments:			
Short-term investments	3,005	3,469	(464)
Cash and cash equivalents	6,766	2,052	4,714
Total Treasury Investments	**9,771**	**5,521**	**4,250**
Net Debt	**(21,319)**	**(23,543)**	**2,224**

INVESTMENTS Appendix 1

Table 3: Investments at 31 March 2019

Counterparty		
	£'000	**£'000**
Money Market Funds (MMF)		
CCLA		420
Federated		1,500
Royal London		1,549
Total Short Term Investments		**3,469**

Table 4: Benchmarking Information



TREASURY MANAGEMENT INDICATORS Appendix 2

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

Table 5: Security

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

	2018/19 Target	30.09.2018 Actual	31.12.2018 Actual	31.03.2019 Actual	2019/20 Target	Complied ?
Portfolio average credit rating	A+	AA+	A+	A+	A+	Yes

Table 6: 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:

	2018/19 Target	30.09.2018 Actual	31.12.2018 Actual	31.03.2019 Actual £m	2019/20 Target	Complied ?
Minimum limit at less than 31 days duration	£9m	£11.5m	£6.3m	5.0	£9m	No
Minimum limit overnight	£3m	£7m	£6.3m	3.4	£3m	Yes

Table 7: Interest Rate Exposures

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

	2018/19 Limit	2018/19 Revised Limit	30.09.2018 Actual	31.12.2018 Actual	31.03.2019 Actual	Complied ?
Upper limit on fixed interest rate exposure	100%	100%	96%	100%	100%	Yes
Upper limit on variable interest rate exposure	30%	**100%**	4%	100%	100%	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.

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:

	2018/19		30.09.2018	31.12.2018	31.03.2019	Complied ?
	Upper Limit	Lower Limit	Actual	Actual	Actual	
Under 12 months	10%	0%	0%	0%	0%	Yes
12 months and within 24 months	15%	0%	0%	0%	0%	Yes
24 months and within 5 years	25%	0%	0%	0%	0%	Yes
5 years and within 10 years	40%	0%	0%	0%	0%	Yes
10 years and above	100%	60%	100%	100%	100%	Yes

TREASURY MANAGEMENT INDICATORS Appendix 2

Table 9: 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:

	2018/19	2019/20	2020/21
Limit on principal invested beyond year end	£3m	£1m	£0m
Actual principal invested beyond year end	£0m	£0m	£0m
Complied?	Yes	Yes	Yes

PRUDENTIAL INDICATORS Appendix 3

Table 10: Debt Limits

Dorset	31 March 2019 Estimate £'000	31 March 2019 Actual £'000	2018/19 Operational Boundary £'000	2018/19 Authorised Limit £'000	Complied
External Borrowing	0	0	34,064	42,064	✓
PFI & Pre 90 Loan	29,064	29,064			✓
Total external debt	**29,064**	**29,064**	**34,064**	**42,064**	✓

Table 11: Capital Financing Requirement (CFR)

Capital Financing Requirement	2018/19 Estimate £'000	2018/19 Actual £'000	Variance £'000
Opening CFR	**32,784**	**32,781**	**-3**
Plus: PFI capital expenditure		521	521
Less:			
Minimum Revenue Provision	(527)	(530)	-3
PFI repayments	(1,906)	(2,427)	-521
Other debt repayments	(120)	(120)	
Closing CFR	**30,231**	**30,225**	**-6**

Table 12: Capital Expenditure and financing

Capital Expenditure and Financing	2018/19 Estimate £'000	2018/19 Actual £'000	Variance £'000
Total Capital Expenditure	**7,898**	**7,182**	**-716**
Capital Receipts	6,773	4,173	-2,600
Government Grants	412	2,488	2,076
Reserves	4		-4
Revenue Contributions	709		-709
PFI		521	521
Total Financing	**7,898**	**7,182**	**-716**

*n.b. PFI capital additions are now reflected in the actual figures. They were not included in the estimate at the start of the year.

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' 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 show 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.