



AGENDA NO: 10a

INDEPENDENT AUDIT COMMITTEE – 29 JULY 2020

TREASURY MANAGEMENT OUTTURN 2019/20

REPORT BY NICOLA ALLEN

PURPOSE OF THE REPORT

The purpose of this report is to present the 2019/20 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 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 This report sets out the performance of the treasury management function for the period from 1 April 2019 to 31 March 2020 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 Force Resources Board.
- 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 As at 31 March 2020, all treasury activity complied with the PCC’s Treasury Management Strategy and Investment Strategy as well as all relevant statute, guidance and accounting standards with the exception of 1. The maturity structure of borrowing criteria of under 12 months is set at 10% but as at 31 March it was 17%. This was due to the need to borrow funds on a short term basis to cover operational cashflows. More details can be found in 4.4.

- 1.6 However, during the year there were a total of 22 breaches against the Treasury Management Strategy operational bank account limit of £1.25m, of which 14 could have been avoided. Some of the underlying issues have been addressed through changes in processes. Other issues have arisen with the cashflow model. Due to the number of breaches an audit will be undertaken to review the processes to ensure adherence. The remaining 8 breaches were not in the control of the Treasury Management Team e.g. income being received after the investment cut off times had passed.

2.0 External Context

- 2.1 Annual GDP growth at 1.1%; year-on-year CPI in February was 1.7%, and the Bank Base Rate remained at 0.1%. 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 2020 short term investments and cash equivalents were £15.231m. In the year to March balances ranged between £0.6m and £72m. 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 Ltd. The outturn benchmarking is provided at Appendix 1 - Table 3. The total return of Devon and Cornwall balances was slightly higher (17%) compared with the average of Police and Fire Authorities (0.14%). Market volatility caused by COVID-19 meant that interest rates reduced. This did have an impact on the investments held by Devon and Cornwall but to a lesser extent than the comparators due to the type of instruments held in March 2020.

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 was £4m more than forecast. This increase was 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 10). The in-year borrowing requirement was as planned with minor adjustments to the MRP and Finance Lease balances. The closing CFR position as at 31 March 2020 was £64.532m.
- 4.3 All long term external borrowing has been arranged with PWLB. The next loan to mature will be in 2025.

- 4.4 On the 27 March 2020, short term borrowing of £6m was arranged from a Local Authority to meet fluctuations in cashflow some of which was caused by the government directive of paying invoices on receiving them rather than to their payment terms. This borrowing was repaid on the 7 April 2020.

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 2 Table 3.
- 5.2 Interest receivable for the year to March was £247k compared to a budgeted amount of £383k. There are a number of factors contributing to this reduction: money market return rates ranged from 0.15% to 0.73% compared to a budgeted rate of 0.90% and the capital programme underspent relative to the monthly cash budgeted spending profile. A more accurate spending profile would have released additional funds for investment, increasing interest received and mitigating the impact of lower rates of return.

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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

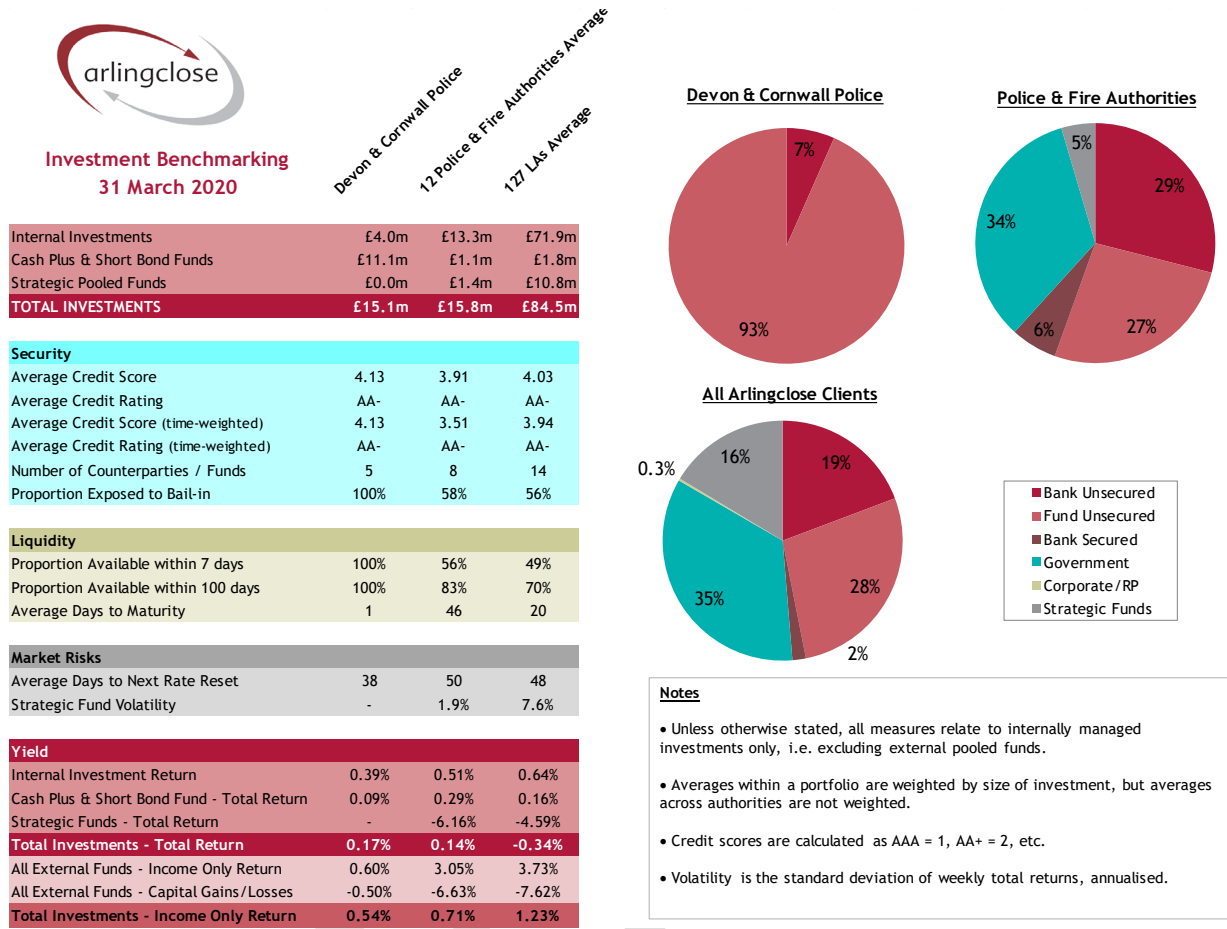
	2019/20 Cash Limit	31.03.20 Actual	Complied?
Any single organisation, except the UK Government	£12m each (£6m unsecured funds)	£6m unsecured	Yes
Any group of organisations under the same ownership	£12m per Group (£6m unsecured funds)	£6m unsecured	Yes
Any group of pooled funds under the same management	£6m per manager	£0	Yes
Negotiable instruments held in a broker's nominee account	£24m per Broker	£0	Yes
Limit per non-UK country	£12m per country	£0	Yes
Registered providers	£20m in Total	£0	Yes
Unsecured investments with building societies	£12m in Total	£0	Yes
Money Market Funds	£32m in Total	£14.99m	Yes
Bank Account	£1.25m	£1.09m	Yes

Table 2: Investment Position

	31.03.19 Actual Portfolio £'000	31.03.20 Actual Portfolio £'000	Movement £'000
External Borrowing - Long Term	(30,277)	(30,277)	0
External Borrowing - Short Term	0	(6,000)	(6,000)
Finance Leases	(279)	(166)	113
Total Gross External Debt	(30,556)	(36,443)	(5,887)
Treasury Investments:			
Short Term Investments	10,203	12,063	1,860
Cash and Cash Equivalents	13,943	3,168	(10,775)
Total Treasury Investments	24,146	15,231	(8,915)
Net Investments/(Debt)	(6,410)	(21,212)	(14,802)

TREASURY MANAGEMENT INDICATORS

Table 3: Benchmarking Information



PRUDENTIAL INDICATORS

Appendix 3

Table 4: 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.

	2019/20	31.03.2020	Complied ?
	Target	Actual	
Portfolio average credit rating	A+	AA-	Yes

Table 5: Interest Rate Exposures

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

	2019/20	31.03.2020	Complied ?
	Limit	Actual	
Upper limit on 1 year revenue impact of a 1% rise in interest rates	£318k	(£121k)	Yes
Upper limit on 1 year revenue impact of a 1% fall in interest rates	(£318k)	£121k	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 6: 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:

	2019/20	31.03.2020	Complied?
	Target	Actual	
Minimum limit at less than 31 days duration	£9m	£15.99m	Yes
Minimum limit overnight	£3m	£9.99m	Yes

PRUDENTIAL INDICATORS

Appendix 3

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:

	Upper Limit	Lower Limit	31.03.2020	Complied?
Under 12 months	10%	0%	17%*	No
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%	5%	Yes
10 years and above	100%	60%	78%	Yes

* This percentage relates to short term borrowing for operational cashflow purposes. Please see 4.4.

Table 8: 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:

	2019/20
Limit on principal invested beyond year end	£10m
Actual principal invested beyond year end	£0m
Complied?	Yes

PRUDENTIAL INDICATORS

Appendix 3

Table 9: Debt Limits

	2019/20	31.03.2020	Operational Boundary	Authorised Limit
	Estimate	Actual		
	£'000	£'000		
External Borrowing	42,277	30,277	52,995	62,995
Finance Leases	718	166		
Total External Liabilities	42,995	30,443	Complied	Complied
Internal Borrowing	17,555	34,089		
Total Debt	60,550	64,532		

Table 10: Capital Financing Requirement (CFR)

	2019/20	2019/20	2019/20
	Estimate	Actual	Variance
	£'000	£'000	£'000
Opening CFR	45,321	49,314	3,993
Capital expenditure to be funded by borrowing	16,983	16,983	0
Finance Leases	0	0	0
Less: Minimum Revenue Provision	(1,584)	(1,652)	(68)
Less: Finance Leases	(171)	(113)	58
Closing CFR	60,550	64,532	3,984

Table 11: Capital Expenditure and Financing

	2019/20	2019/20
	Estimate	Actual
	£'000	£'000
Capital Expenditure	38,882	28,014
REFCUS	0	164
Total Expenditure	38,882	28,178
Capital Receipts	4,677	0
Government Grants	1,104	1,496
Reserves	12,513	6,097
Revenue	3,605	3,602
Borrowing	16,983	16,983
Total Financing	38,882	28,178

External Context

Economic background: The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

The headline rate of UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from of 2.5% to range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a \$2 trillion fiscal stimulus package. With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

Financial markets: Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touch its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-

year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

Since the start of the calendar 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

Credit review: In Q4 2019 Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative. The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS. While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as cutting Close Brothers long-term rating to A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.