AGENDA NO: 10b

INDEPENDENT AUDIT COMMITTEE – 29 JULY 2020

TREASURY MANAGEMENT OUTTURN 2019/20

REPORT BY JULIE STRANGE

PURPOSE OF THE REPORT

The purpose of this report is to present the 2019/20 treasury management outturn for Dorset, for comment prior to approval by the PCC.

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. 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 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. As at 31st March 2020, all treasury activity fully complied with the PCC's Treasury Management Strategy and Investment Strategy as well as all relevant statute, guidance and accounting standards. However, during the year there were a total of 15 breaches against the Treasury Management Strategy operational bank account limit of £1.25m, of which 8 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 7 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. 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. Investment Activity

3.1. At 31st March 2020 short term investments and cash equivalents were £12.356m. In the year to March balances ranged between £0.1m and £32m. A Treasury Management summary showing the investment and borrowing 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 Dorset balances was higher compared with the average of Police and Fire Authorities by 0.26% (0.40% Dorset and 0.14% Police and Fire Authorities average). The total of investments held by Dorset as at 31st March 2020 was less than the average of the comparators. Market volatility caused by COVID-19 meant that interest rates reduced. This did have an impact on the investments held by Dorset but to a lesser extent than the comparators due to the type of instruments held in March 2020.

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 31st March 2020 Dorset's underlying need to borrow for capital purposes / CFR was £30.802m. 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 reserve contributions. This decision was established by reviewing the level of reserves held at 31 March 2020 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).

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 2020 was £4.663m. 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 2020 was £21.311m. Government grants are received annually towards the costs of these schemes.

4.4. On the 31st March 2020, short term borrowing of £5.5m 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 9th April 2020.

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 3.

5.2. Interest receivable for the year to March was £106k 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.

6. <u>Other Issues</u>

6.1. The collapse of Icelandic banks in 2008 leaves an outstanding balance of £37k out of a claim totalling £2,035,104 in respect of a temporary loan of £2m to Heritable Bank Ltd (now in administration). A letter received in February 2020 advises that a final payment will be made in July.

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

	2019/20 Cash Limit	**31st March 2020 Actual**	**Complied?**
Any single organisation, except the UK Government	£1m each (£0.5m unsecured funds)	£1m each with the exception of DMO (£3.2m)	Yes
Any group of organisations under the same ownership	£1m per Group (£0.5m unsecured funds)	£0m	Yes
Any group of pooled funds under the same management	£1m per manager	£0m	Yes
Negotiable instruments held in a broker's nominee account	£12m per Broker	£0m	Yes
Limit per non-UK country	£1m per country	£0m	Yes
Registered providers	£3m in Total	£0m	Yes
Unsecured investments with building societies	£3m in Total	£0m	Yes
Money Market Funds	£12m in Total	£4m in Total	Yes
Bank Account	£1.25m in Total	£1.068m in Total	Yes

Table 2: Treasury Management Summary

	31st March 2019 Actual Portfolio £'000	**31st March 2020 Actual Portfolio £'000**	**Year on Year Change £'000**
External Borrowing:			
Short-term borrowing	0	(5,500)	(5,500)
Total External Borrowing	**0**	**(5,500)**	**(5,500)**
Other Long-Term Liabilities:			
Private Finance Initiative	(27,978)	(25,974)	2,004
Other long term liabilities	(1,086)	(966)	120
Total Other Long-Term Liabilities	**(29,064)**	**(26,940)**	**2,124**
Total Gross External Debt	**(29,064)**	**(32,440)**	**(3,376)**
Treasury Investments:			
Short-term investments	3,469	3,001	(468)
Cash and cash equivalents	2,052	9,355	7,303
Total Treasury Investments	**5,521**	**12,356**	**6,835**
Net Debt	**(23,543)**	**(20,084)**	**3,459**

TREASURY MANAGEMENT INDICATORS

Appendix 2

Table 3: Benchmarking Information

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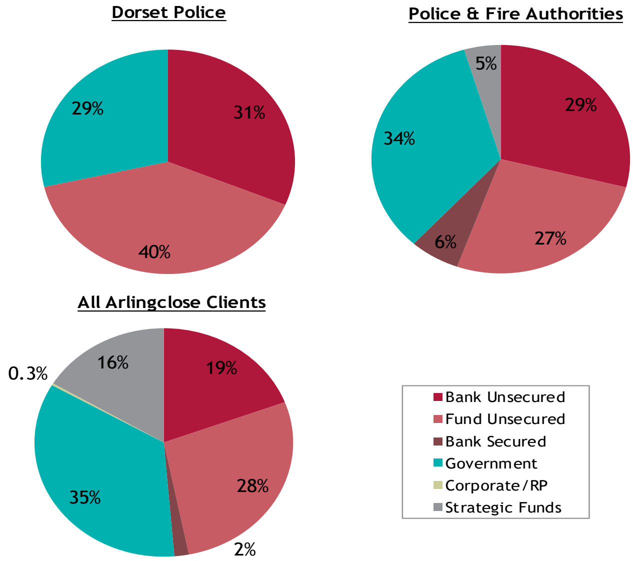
Investment Benchmarking
31 March 2020

	Dorset Police	12 Police & Fire Authorities Average	127 LAs Average
Internal Investments	£10.2m	£13.3m	£71.9m
Cash Plus & Short Bond Funds	£1.0m	£1.1m	£1.8m
Strategic Pooled Funds	£0.0m	£1.4m	£10.8m
TOTAL INVESTMENTS	**£11.2m**	**£15.8m**	**£84.5m**
Security			
Average Credit Score	4.13	3.91	4.03
Average Credit Rating	AA-	AA-	AA-
Average Credit Score (time-weighted)	4.79	3.51	3.94
Average Credit Rating (time-weighted)	A+	AA-	AA-
Number of Counterparties / Funds	13	8	14
Proportion Exposed to Bail-in	69%	58%	56%
Liquidity			
Proportion Available within 7 days	82%	56%	49%
Proportion Available within 100 days	100%	83%	70%
Average Days to Maturity	17	46	20
Market Risks			
Average Days to Next Rate Reset	34	50	48
Strategic Fund Volatility	-	1.9%	7.6%
Yield			
Internal Investment Return	0.39%	0.51%	0.64%
Cash Plus & Short Bond Fund - Total Return	0.48%	0.29%	0.16%
Strategic Funds - Total Return	-	-6.16%	-4.59%
Total Investments - Total Return	**0.40%**	**0.14%**	**-0.34%**
All External Funds - Income Only Return	0.91%	3.05%	3.73%
All External Funds - Capital Gains/Losses	-0.42%	-6.63%	-7.62%
Total Investments - Income Only Return	**0.43%**	**0.71%**	**1.23%**



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.

PRUDENTIAL INDICATORS Appendix 3

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	31st March 2020	Complied ?
	Target	Actual	
Portfolio average credit rating	A+	AA-	Yes

The AA credit rating is a higher rating than A+.

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	31st March 2020	Complied ?
	Target	Revised Target	Actual	
Minimum limit at less than 31 days duration	£9m	£6m	£9.2m	Yes
Minimum limit overnight	£3m	£3m	£9.2m	Yes

In response to COVID-19, the Government issued a direction to pay invoices when received rather than on the payment terms. A decision was therefore taken to ensure that we had a good level of overnight funds available.

Table 6: Interest Rate Exposures

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

	2019/20	31st March 2020	Complied ?
	Limit	Actual	
Upper limit on 1 year revenue impact of a 1% rise in interest rates	£60k	(£45k)	Yes
Upper limit on 1 year revenue impact of a 1% fall in interest rates	(£60k)	£45k	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.

PRUDENTIAL INDICATORS Appendix 3

Table 7: Maturity Structure of Borrowing

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

	2019/20		31st March 2020	Complied ?
	Upper Limit	Lower Limit	Actual	
Under 12 months	50%	0%	17%*	Yes
12 months and within 24 months	50%	0%	0%	Yes
24 months and within 5 years	50%	0%	0%	Yes
5 years and within 10 years	50%	0%	4%	Yes
10 years and above	100%	0%	79%	Yes

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

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
Complied ?	Yes

Table 9: Debt Limits

	2019/20	31st March 2020	Operational Boundary	Authorised Limit
	Estimate	Actual		
	£'000	£'000	£'000	£'000
PFI Liabilities	25,975	25,975		
Other Long Term Liabilities	966	1,083	**36,940**	**41,940**
External Borrowing	0	0		
Total External Liabilities	**26,941**	**27,058**	**Complied**	**Complied**
Internal Borrowing	1,804	3,744		
Total Debt	**28,745**	**30,802**		

PRUDENTIAL INDICATORS Appendix 3

Table 10: Capital Financing Requirement (CFR)

	2019/20 Estimate £'000	2019/20 Actual £'000	2019/20 Variance £'000
Opening CFR	**30,225**	**30,225**	**0**
Capital expenditure to be funded by internal borrowing	1,173	3,113	1,940
Capital expenditure to be funded by PFI	0	511	511
Capital expenditure to be funded by Finance Leases	0	118	118
Less: Repayment of PFI	(2,004)	(2,515)	(511)
Less: Repayment of Other Long Term Liabilities	(120)	(120)	0
Less: Minimum Revenue Provision	(530)	(530)	0
Closing CFR	**28,745**	**30,802**	**2,058**

Table 11: Capital Expenditure and Financing

	2019/20 Estimate £'000	2019/20 Actual £'000
Capital Expenditure	8,356	6,213
PFI Expenditure	0	511
Finance Lease Expenditure	0	118
REFCUS	**0**	3,715
Total Expenditure	**8,356**	**10,557**
Capital Receipts	5,662	684
Government Grants	421	4,336
Reserves	0	665
Revenue	1,100	1,130
Borrowing	1,173	3,113
PFI Liabilities	0	511
Finance Lease Liabilities	0	118
Total Financing	**8,356**	**10,557**

ECONOMIC UPDATE PROVIDED BY ARLINGCLOSE LTD Appendix 4

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 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-.