

## AGENDA NO: 8a



### INDEPENDENT AUDIT COMMITTEE – 11 DECEMBER 2018

### 2018/19 TREASURY MANAGEMENT MID-YEAR MONITORING

### REPORT BY NICOLA ALLEN

#### 1. PURPOSE OF THE REPORT

- 1.1 The purpose of this report is to present the 2018/19 treasury management mid-year monitoring for Devon and Cornwall.

#### 2. INTRODUCTION

- 2.1 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.
- 2.2 The Code also recommends a report on Treasury Management activities at least twice a year; a mid-year, and a year-end report. This report therefore complies with best practice in accordance with CIPFA's recommendations.
- 2.3 Treasury management is defined as:  
  
*"The management of the OPCC'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".*
- 2.4 This mid-year report sets out the performance of the treasury management function for the six months to September 2018. 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.
- 2.5 In the light of experience in the year to date, and after taking advice from our treasury management advisors, one minor revision has been made to the treasury indicators as follows:-

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- Investment limits (see Appendix 1, Table 1) one limit have been increased to provide more flexibility to optimise returns, better reflecting the short term nature of fluctuating balances.

2.6 In the year to September 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.

### **3. EXTERNAL CONTEXT**

3.1 In quarter 2, GDP grew to 0.4%; year-on-year CPI rose to 2.7%, an increase of 0.3% on the quarter 1 reported figures; and the Bank Base Rate increased by 0.25% in August 2018 to 0.75%. A fuller explanation of the external context, as provided by the Treasury Management Advisors Arlingclose Limited, is provided in Appendix 4.

### **4. INVESTMENT ACTIVITY**

4.1 At 30 September 2018 Devon and Cornwall had short term investments and cash equivalents of £58.3m. In the year to September 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.

4.2 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.

4.3 Investments are reviewed quarterly and benchmarked against other similar organisations by Arlingclose Limited. The benchmarking for quarter 2 is provided at Appendix 1 - Table 3. Compared with the average of Police and Fire Authorities Devon and Cornwall balances are lower. Arlingclose has 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.

### **5. BORROWING ACTIVITY**

5.1 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.

5.2 At 30 September 2018 the forecast underlying need to borrow for capital purposes /CFR was £37.9m, and the year end forecast is in line with the estimate in the Treasury Management Strategy (see Appendix 3 Table 10).

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

### **6. PERFORMANCE REPORT**

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- 6.1 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.
- 6.2 Interest receivable for the year to September was £142k and the full year forecast is £319k which is lower than the budgeted amount of £383k. The lower forecast is mainly due to changes in the cashflow profiling of income and expenditure. At certain points during the remainder of the year the cashflow is forecast to dip towards minimum limits. To ensure that we have enough liquidity to meet known commitments and working within the treasury minimum limits, investing in instruments for long periods of time are not feasible and as a consequence reduces the level of interest that can be earned.
- 6.3 The average rate vs credit risk has improved since September 2017 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

## **7. RECOMMENDATIONS**

- 7.1 It is recommended that the Independent Audit Committee considers the report and makes observations as appropriate.

**Lucinda Hines**  
**Head of Technical Accounting**

**Nicola Allen**  
**Treasurer to the OPCC**

### **Appendices**

- Appendix 1 – Investments
- Appendix 2 – Treasury Management Indicators
- Appendix 3 – Prudential Indicators
- Appendix 4 – Economic Update

**INVESTMENTS**

**Table 1: Investment Limits**

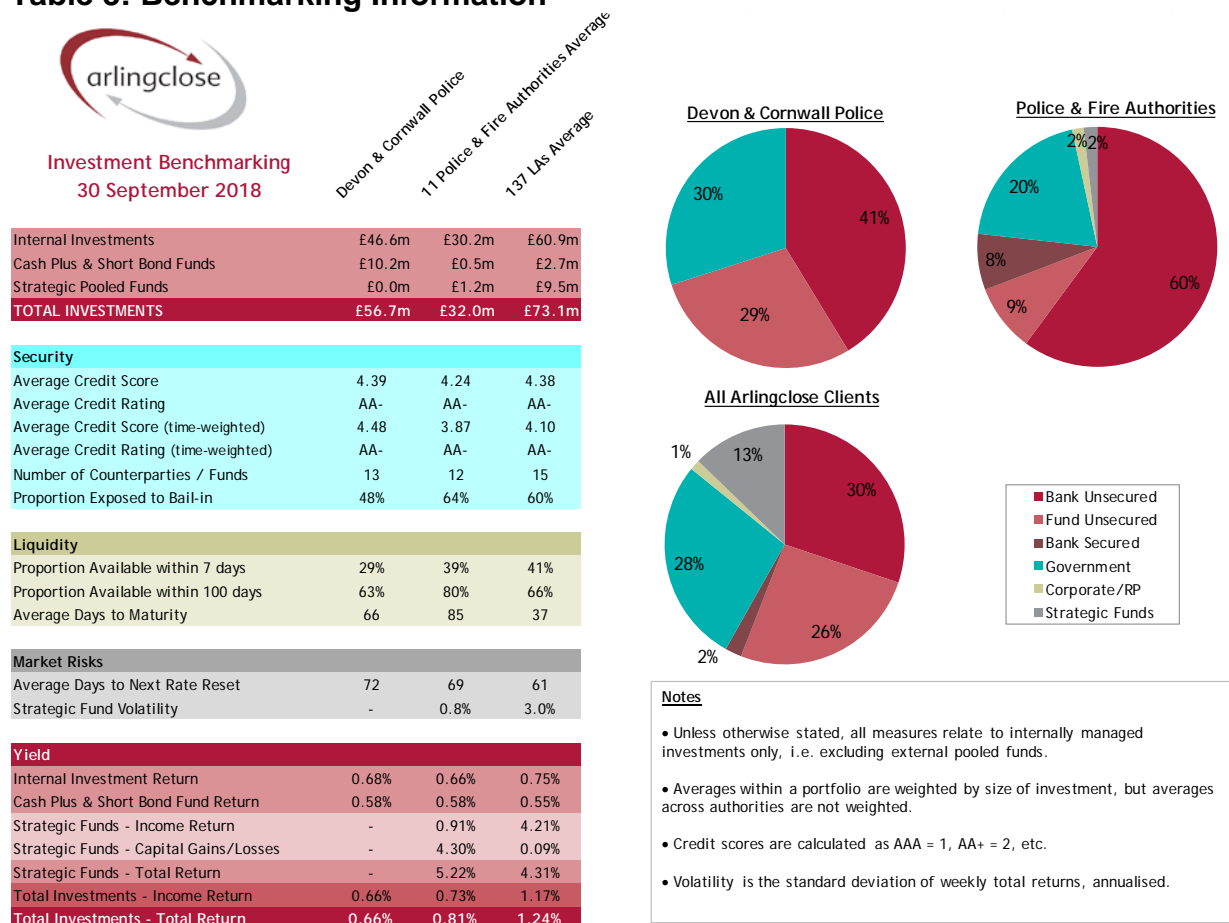
	<b>30.09.18 Actual</b>	<b>2018/19 Cash Limit</b>	<b>2018/19 Revised Cash Limit</b>	<b>Complied?</b>
Any single organisation, except the UK Government	£6m unsecured funds	£12m each (£6m unsecured funds)	£12m each (£6m unsecured funds)	Yes
Any group of organisations under the same ownership	£8m (£6m unsecured funds and £2m secured funds)	£12m each (£6m unsecured funds)	£12m each (£6m unsecured funds)	Yes
Any group of pooled funds under the same management	£4m	£6m per manager	£6m per manager	Yes
Negotiable instruments held in a broker's nominee account	£21.4m	£20m per broker	<b>£24m per broker</b>	Yes
Limit per non-UK country	£0	£12m per country	£12m per country	Yes
Registered providers	£0	£20m in total	£20m in total	Yes
Unsecured investments with building societies	£5m	£12m in total	£12m in total	Yes
Money Market Funds	£14.1m	£32m in Total	£32m in Total	Yes
Bank Account	£1.7m	£2.25m	£2.25m	Yes

**INVESTMENTS**

**Table 2: Investment Position**

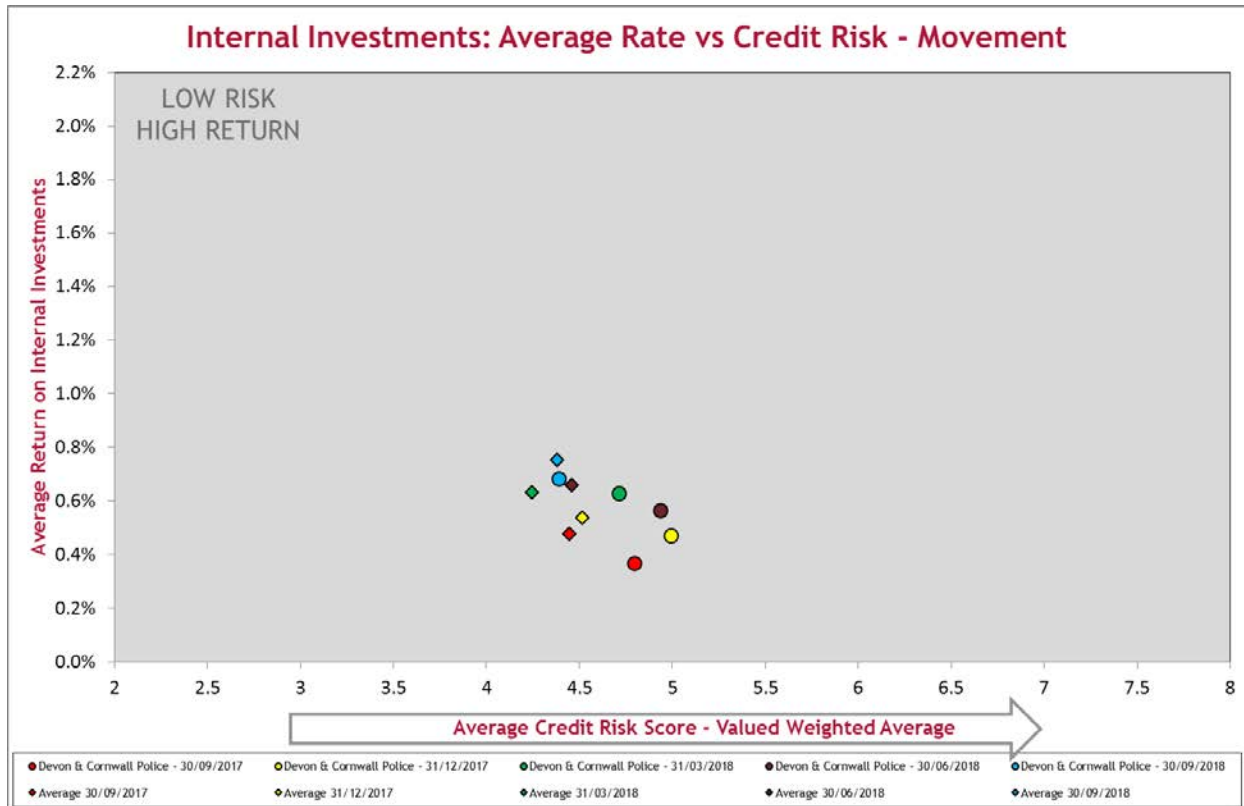
	<b>31.03.18 Balance £'000</b>	<b>30.09.18 Balance £'000</b>	<b>Movement £'000</b>
Long-term Debt	(30,277)	(30,277)	0
Short-term borrowing	0	0	0
<b>Total borrowing</b>	<b>(30,277)</b>	<b>(30,277)</b>	<b>0</b>
Long-term investments	0	0	0
Short-term investments	33,600	48,430	14,830
Cash and cash equivalents	4,580	8,120	3,540
<b>Total investments</b>	<b>38,180</b>	<b>56,550</b>	<b>18,370</b>
<b>Net borrowing</b>	<b>7,903</b>	<b>26,273</b>	<b>18,370</b>

**Table 3: Benchmarking Information**



INVESTMENTS

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.

	<b>2018/19 Target</b>	<b>30.09.18 Actual</b>	<b>Complied?</b>
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.

	<b>2018/19 TMS Limit</b>	<b>30.09.18 Actual</b>	<b>Complied?</b>
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.

**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:

	<b>Upper Limit</b>	<b>Lower Limit</b>	<b>30.09.18 Actual</b>	<b>Complied</b>
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 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:

	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
Limit on principal invested beyond year end	£20m	£10m	£5m
Actual principal invested beyond year end	£0m	£0m	£0m
Complied?	Yes	Yes	Yes



**PRUDENTIAL INDICATORS**

Appendix 3

**Table 9: Debt Limits**

	<b>2018/19 Estimate £'000</b>	<b>30.09.18 Actual £'000</b>	<b>2018/19 Operational Boundary £'000</b>	<b>2018/19 Authorised Limit £'000</b>	<b>Complied?</b>
External Borrowing	30,277	30,277	40,871	46,871	Yes
Other Long Term Liabilities	594	0			
<b>Total external debt</b>	<b>30,871</b>	<b>30,277</b>	<b>40,871</b>	<b>46,871</b>	

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

	<b>2018/19 Estimate £'000</b>	<b>30.09.18 Actual £'000</b>	<b>2018/19 Forecast £'000</b>
<b>Opening CFR</b>	<b>39,781</b>	<b>38,915</b>	<b>38,915</b>
Capital expenditure to be funded by borrowing	7,852	0	7,200
Finance Lease	0	0	0*
Less: Minimum Revenue Provision	(1,570)	(823)	(1,646)
Less: Finance Lease	(119)	(113)	0
<b>Closing CFR</b>	<b>45,944</b>	<b>37,979</b>	<b>44,469</b>

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

## External Context

### Economic background:

Oil prices rose by 23% over the six months to around \$82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29<sup>th</sup> March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

### Financial markets:

Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the net change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

**Credit background:**

Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.