

## AGENDA NO: 8b



### INDEPENDENT AUDIT COMMITTEE - 11 December 2018

### TREASURY MANAGEMENT MID-YEAR MONITORING 2018-19 – DORSET PCC

### REPORT BY ALEXIS GARLICK

### PURPOSE OF THE REPORT

The purpose of this report is to present the 2018/19 treasury management mid-year monitoring 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 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.
- 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 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.
- 1.5 In the light of experience in the year to date, and after taking advice from our treasury management advisors, some minor revisions are being made to the treasury and prudential indicators as follows:-
  - Investment limits (see Appendix 1, Table 1) some limits are being increased to provide more flexibility to optimise returns, better reflecting the short term nature of fluctuating balances.

- Interest Rate exposures (see Appendix 1, Table 5) – the upper limit on variable interest rate exposure is being increased from 30% to 100% to provide full flexibility to choose the optimum strategy between fixed and variable rates.

1.6 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.

## **2. EXTERNAL CONTEXT**

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.

## **3. INVESTMENT ACTIVITY**

3.1 At 30 September 2018 Dorset had short term investments and cash equivalents of £14.5m. In the year to September 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 Limited. The benchmarking for quarter 2 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.

## **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.

At 30 September 2018 the forecast underlying need to borrow for capital purposes / CFR was £31.5m, and the year end forecast is in line with the estimate in the Treasury Management Strategy (see Appendix 3 Table 11).

4.2 Most of the CFR 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 30 September 2018 was £5.956m. 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 30 September 2018 was £22.975m. Government grants are received annually towards the costs of these schemes.

## **5. 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 4.
- 5.2 Interest receivable for the year to September was £25k and the full year forecast is £61k which is lower than budgeted mainly because of lower average balances than estimated.

## **6. OTHER ISSUES**

### **Markets in Financial Instruments Directive (MiFID)**

In January 2018, the way that Local Authorities accessed financial services changed as a result of the second Markets in Financial Instruments Directive (MiFID II). This Directive is the framework for investment intermediaries and trading of financial instruments and has been revised to improve the functioning of financial markets in light of the last financial crisis and to strengthen investor protection.

MiFID II requires all Local Authorities, including PCCs, to be classed as retail clients unless they opt up to professional client status. As a retail client access to financial services is reduced, there is greater administration and higher fees. After taking advice from our external Treasury Management advisors, Arlingclose, the PCC “opted up” to professional client status at the 31 March 2017.

Given that balances fluctuate across the year, we sought further clarification from Arlingclose to establish whether it was possible to maintain professional client status, should balances drop below the required £10m at the year end. The advice received is that the position should be monitored and may require action if the cash flow level dropped below the threshold for a prolonged period of time. This is currently not expected to be the case.

## **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**

**Alexis Garlick**  
**Chief Finance Officer for Dorset 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	£1.5m unsecured	£3m each	£3m each	Qtr1 - The investment limits were decreased in 2018/19 by 50%. An investment of £3m held at 30/06/2018 was one that was taken out in 2017/18 and complied with the strategy in that year.  Qtr2 - Yes
Any group of organisations under the same ownership	£0	£3m each (£1.5m unsecured funds)	£3m each (£1.5m unsecured funds)	Yes
Any group of pooled funds under the same management	£0	£3m per manager	£3m per manager	Yes
Negotiable instruments held in a broker's nominee account	£4.5m	£6m per broker	<b>£12m per broker</b>	Yes
Limit per non-UK country	£0	£3m per country	£3m per country	Yes
Registered providers	£0	£6m in total	£6m in total	Yes
Unsecured investments with building societies	£1.5m	£3m in total	<b>£6m in total</b>	Yes
Money Market Funds	£4.8m	£6m in Total	<b>£12m in Total</b>	Yes
Bank Account	£2.23m	£2.25m	£2.25m	Yes

**INVESTMENTS**

Appendix 1

**Table 2: Treasury Management Summary**

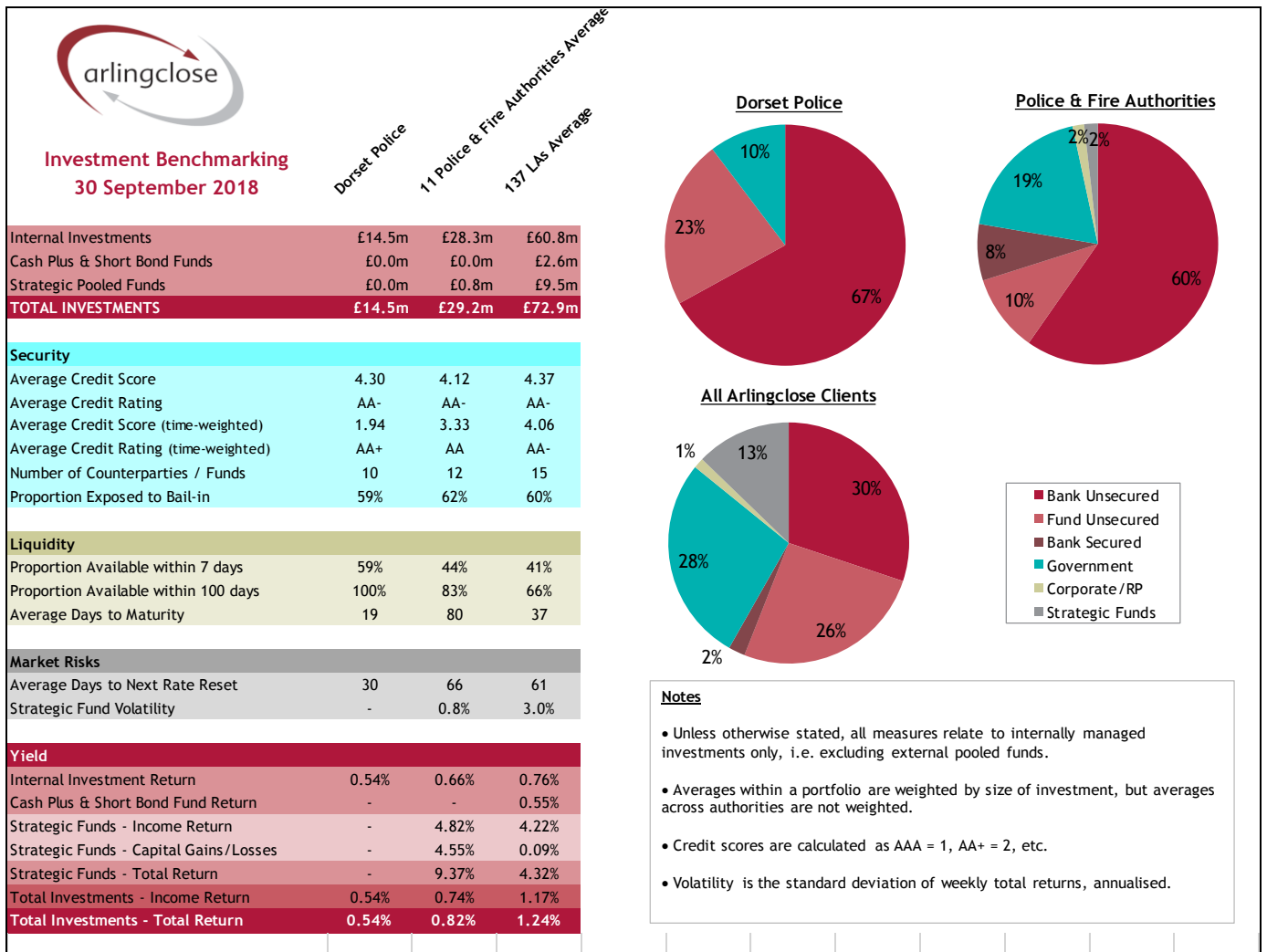
	<b>31.03.18</b>	<b>30.09.18</b>	<b>Movement</b>
	<b>Balance</b>	<b>Balance</b>	
	<b>£'000</b>	<b>£'000</b>	<b>£'000</b>
Long-term Debt	(31,090)	(30,076)	1,014
Short-term borrowing	0	0	0
<b>Total borrowing</b>	<b>(31,090)</b>	<b>(30,076)</b>	<b>1,014</b>
Long-term investments	0	0	0
Short-term investments	3,005	7,500	4,495
Cash and cash equivalents	6,928	7,018	90
<b>Total investments</b>	<b>9,933</b>	<b>14,518</b>	<b>4,585</b>
<b>Net borrowing</b>	<b>(21,157)</b>	<b>(15,558)</b>	<b>5,599</b>

**Table 3: Investments at 30 September 2018**

<b>Counterparty</b>	<b>Funds</b>	<b>Total</b>
	<b>£</b>	<b>£</b>
<u>Bank Account</u>		
Natwest	<u>2,228,295</u>	<b>2,228,295</b>
<u>Money Market Funds</u>		
Standard Life	290,000	
Federated	1,500,000	
Deutsche	1,500,000	
Legal and General	<u>1,500,000</u>	
<b>Total MMF</b>		<b>4,790,000</b>
<u>Investment Funds</u>		
Nationwide Building Society	1,500,000	
King & Shaxson Treasury Bills	1,500,000	
Royal Bank of Canada	1,500,000	
KFW	1,500,000	
Bank Nederlandse Gemeenten NV	<u>1,500,000</u>	
<b>Total Investment Funds</b>		<b><u>7,500,000</u></b>
<b>Total</b>		<b><u>14,518,295</u></b>

INVESTMENTS

Table 4: Benchmarking Information



**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: 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:

	<b>Target</b>	<b>Actual</b>	<b>Complied?</b>
Minimum limit at less than 31 days duration	£9m	£11.5m	Yes
Minimum limit overnight	£3m	£7m	Yes

**Table 7: Interest Rate Exposures**

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

	<b>2018/19 TMS Limit</b>	<b>2018/19 Revised Limit</b>	<b>30.09.18 Actual</b>	<b>Complied?</b>
Upper limit on fixed interest rate exposure	100%	100%	96%	Yes
Upper limit on variable interest rate exposure	30%	<b>100%</b>	4%	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:

	<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%	0%	Yes
10 years and above	100%	60%	100%	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:

	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
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**

**Table 10: 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>
PFI liabilities	27,978	28,931	34,064	42,064	Yes
Other long term liabilities	1,086	1,146			
Internal borrowing	1,167	1,426			
<b>Total debt</b>	<b>30,231</b>	<b>31,503</b>	<b>34,064</b>	<b>42,064</b>	

**Table 11: 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>32,784</b>	<b>32,781</b>	<b>32,781</b>
Capital expenditure to be funded by borrowing	0	0	0
Less: Repayment of PFI	(1,906)	(953)	(1,906)
Less: Repayment of Other Long Term Liabilities	(120)	(60)	(123)
Less: Minimum Revenue Provision	(527)	(265)	(530)
<b>Closing CFR</b>	<b>30,231</b>	<b>31,503</b>	<b>30,222</b>

**Table 12: Capital Expenditure and financing**

	<b>2018/19 Estimate £'000</b>	<b>30.09.18 Actual £'000</b>	<b>2018/19 Forecast £'000</b>
<b>Total Capital Expenditure</b>	<b>7,898</b>	<b>1,255</b>	<b>6,480</b>
Capital Receipts	6,773	843	5,037
Government Grants	412	412	412
Reserves	4	0	203
Revenue	709	0	792
Borrowing	0	0	0
Leasing and PFI	0	0	0
<b>Total Financing</b>	<b>7,898</b>	<b>1,255</b>	<b>6,444</b>

## **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 money market 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.