APPENDIX A: ANNUAL TREASURY MANAGEMENT REVIEW 2018/19

1. Introduction

The Police & Crime Commissioner (PCC) is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2018/19. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2018/19 the minimum reporting requirements were that the PCC should receive the following reports:

- an annual treasury strategy in advance of the year (PCC decision 015-2018 29/03/2018);
- a mid-year treasury update report (Resource Governance paper 26/11/2018);
- an annual review following the end of the year describing the activity compared to the strategy (this report).

The regulatory environment places responsibility on JIAC for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the policies previously approved by the PCC.

The Resource Governance Board confirms that it has complied with the requirement under the Code to scrutinise treasury management reports.

2. The PCC's Capital Expenditure and Financing

The PCC undertakes capital expenditure on long-term assets. These activities may either be:

- financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the PCC's borrowing need; or
- if insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital Expenditure and Financing (£m)	2017/18 Actual	2018/19 Revised Budget	2018/19 Actual
Capital expenditure	11.9	21.3	16.4
Financed in year	7.9	6.8	5.8
Unfinanced capital expenditure	4.0	14.5	10.6

3. The PCC's Overall Borrowing Need

The PCC's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the PCC should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2017/18) plus the estimates of any additional capital financing requirement for the current (2018/19) and next two financial years. This essentially means that the PCC is not borrowing to support revenue expenditure. This indicator allowed the PCC some flexibility to borrow in advance of its immediate capital needs in 2018/19. The table below highlights the PCC's gross borrowing position against the CFR. The PCC has complied with this prudential indicator.

Gross Borrowing and CFR (£m)	31-Mar-18 Actual	31-Mar-19 Revised Budget	31-Mar-19 Actual
Capital Financing Requirement	31.3	43.9	39.8
Borrowing	11.6	29.9	28.7
Other long term liabilities*	7.1	7.1	6.9
Over / (under) borrowing	(12.6)	(6.9)	(4.2)

*includes the finance lease liability for the ICT assets transferred to G4S.

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the PCC does not have the power to borrow above this level. The table below demonstrates that during 2018/19 the PCC has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the PCC during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Authorised Limit and Operational Boundary (£m)	2018/19
Authorised limit	53.0
Maximum gross borrowing position during the year	35.6
Operational boundary	48.0
Average gross borrowing position	27.1
Financing costs as a proportion of net revenue stream	2.09%

4. Treasury Position as at 31 March 2019

At the beginning and the end of 2018/19 the PCC's treasury position (excluding borrowing by PFI and finance leases) was as follows:

Treasury Position (£m)	31-Mar-18 Principal	31-Mar-19 Principal
Total debt	11.6	28.7
Capital Financing Requirement	31.3	39.8
Other long term liabilities	(7.1)	(6.9)
Underlying Borrowing Need	24.2	32.9
Over / (under) borrowing	(12.6)	(4.2)
Total investments	2.4	8.1
Net debt	9.2	20.6

The maturity structure of the debt portfolio was as follows:

Maturity Structure (£m)	31-Mar-18 Actual	31-Mar-19 Actual
Under 12 mths	1.0	1.1
12 mths and within 24 mths	1.0	0.8
24 mths and within 5 yrs	2.5	2.4
5 yrs and within 10 yrs	1.3	3.6
10 yrs and within 20 yrs	5.8	2.8
40 yrs and within 50 yrs	-	18.0

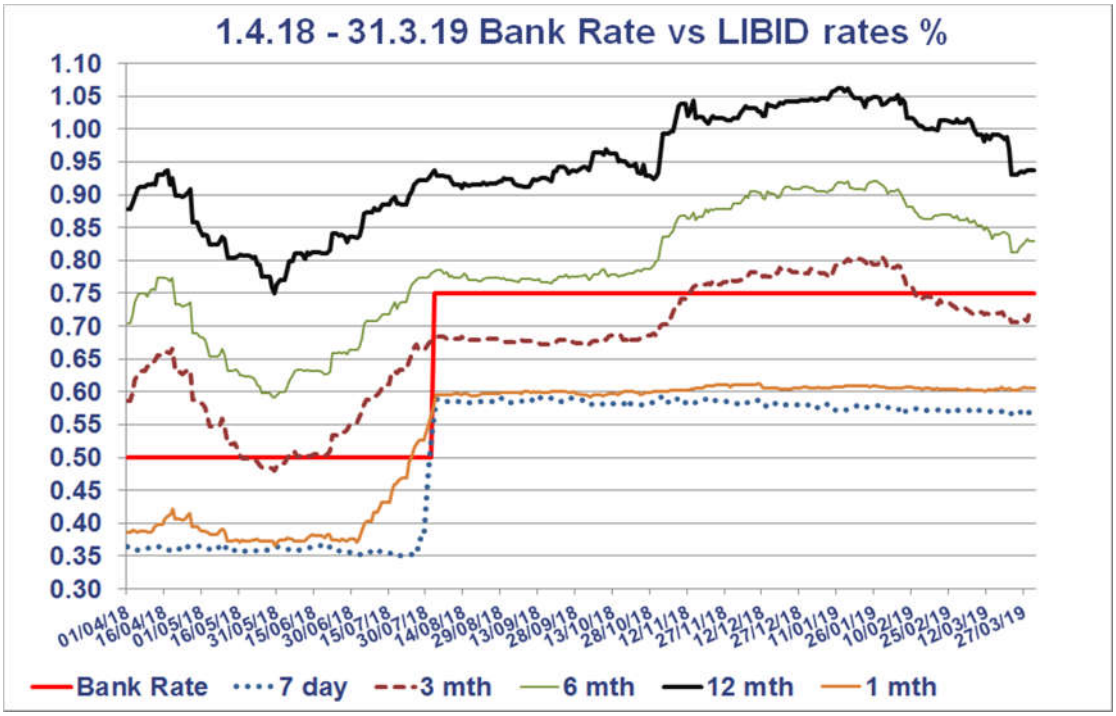
The maturity structure of the investment portfolio was as follows:

Investments (£m)	31-Mar-18	31-Mar-19
Longer than 1 year	-	-
Up to 1 year	2.4	8.1
Total	2.4	8.1

All investments were made for up to one year.

5. The Strategy for 2018/19

Investment strategy and control of interest rate risk



Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018. During this period, investments were, therefore, kept shorter term in anticipation that rates would be higher later in the year.

It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit having been due in March 2019. Value was therefore sought by placing longer term investments after 2 August where cash balances were sufficient to allow this.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has promoted a cautious approach whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

Borrowing strategy and control of interest rate risk

During 2018-19, the PCC maintained an under-borrowed position. This meant that the capital borrowing need (the Capital Financing Requirement) was not fully funded with loan debt, as cash supporting the PCC's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this has incurred a revenue cost being the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this was kept under close review in 2018/19 as cash balances were reducing and to avoid incurring higher borrowing costs in the future when the PCC may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

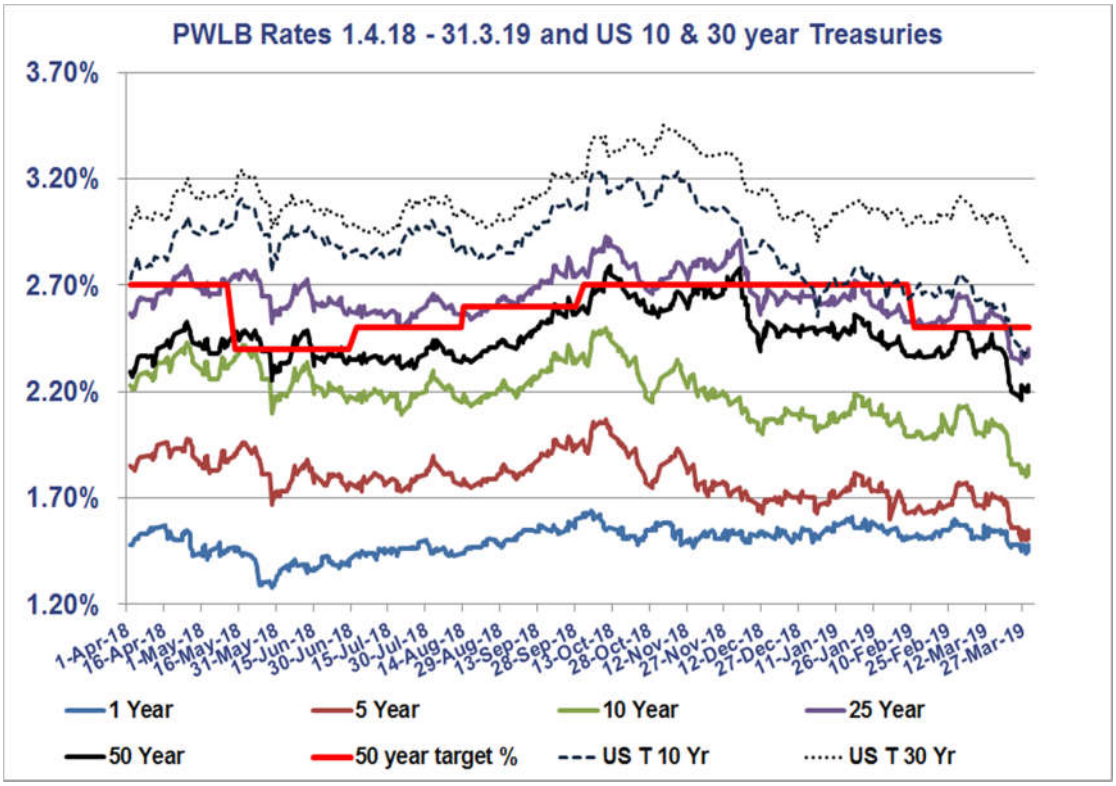
Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Chief Finance Officer therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks*:*

- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered;

- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2018/19 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View 12.2.18													
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB Rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%



Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December and, apart from the 1 year rate, reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018 making nine increases in all in this cycle to reach 2.25% to 2.5% in December. However, it had been giving forward guidance that rates could go up to nearly 3.5%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields/PWLB rates have also fallen.

6. Borrowing Outturn for 2018/19

Borrowing

There has been temporary borrowing in the year, details are shown below:

Amount Borrowed	Number of Days	Interest Rate	Interest Paid (£)
£2.5m	3	0.35%	71.92
£5.5m	20	0.55%	1,657.53
£0.6m	6	0.55%	54.25

Loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt. The loans drawn were:

Lender	Principal	Type	Average Interest Rate	Maturity
PWLB	£18.0m	Fixed interest rate	2.34%	50 yrs

PWLB interest rates dropped to historically low levels during 2018/19, and given that cash balances were reducing such that internal borrowing had to be replaced with external debt, borrowing was taken to secure low interest rates for the longer term. The table below shows that the average interest rate incurred on the debt portfolio reduced from 4.44% to 3.13% as a result of the borrowing taken in year.
The borrowing was taken as PWLB 50 year maturity loans with the loan principals varying from £2M to £5M. Most of the borrowing requirement for 2018/19 was in respect of the Blue Light building project i.e. longer life property assets were being financed. Previously, borrowing had been shorter term repayment debt, so the new borrowing represented a change in borrowing strategy in order to build a long term debt portfolio for the long life assets being acquired. Ideally, borrowing would have been taken with a range of maturities in the 30 to 50 year range to reduce future refinancing risk. The PWLB yield curve shows that interest rates are higher in the 25 to 30 year range than for a 50 year maturity. Given the projected budgetary gaps and the substantial savings required to balance the budget over the Medium Term Financial Plan, advantage has been taken of the lowest interest rates available to minimise borrowing costs. However, to reduce refinancing risk as far as possible, the borrowing was taken as individual loans of smaller principal sums over the course of the year.

Rescheduling

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments

In 2018/19 the PCC repaid £0.8m on the principal on PWLB loans. The outstanding PWLB debt is shown below:

	31-Mar-18	31-Mar-19
Outstanding PWLB debt	£11.2m	£28.4m
Average interest rate	4.44%	3.13%
Average remaining life	14.4 yrs	36.6 yrs

7. Investment Outturn for 2018/19

Investment Policy.

The PCC's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the PCC on 29 March

2018. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The PCC held £8.2m of investments as at 31 March 2019; a breakdown of the investments held is in Appendix A1. During the year, no investments were outstanding with counterparties that were not on the PCC's approved list. Interest receipts during the year were £58k, against a budget of £25k.

Resources

The PCC's cash balances comprise revenue and capital resources and cash flow monies. The PCC's core cash resources were as follows:

Balance Sheet Resources (£k)	31-Mar-18	31-Mar-19
General Fund Balance	5,664	3,232
Earmarked Reserves	10,979	9,227
Provisions	1,217	1,657
Capital Receipts Reserve	-	-
Capital Grants Unapplied	596	292
Total	18,456	14,408

Appendix A1: Investments List as at 31 March 2019

Capita Colour Coding	Investment duration*	Borrower	Principal (£)	Interest Rate	Maturity Date	Lowest Long Term Rating	Historic Risk of Default
Yellow	Up to 5 years	Black Rock MMF	4,000,000	0.74%	MMF	AAA	0.000%
Yellow	Up to 5 years	Aberdeen Standard MMF	4,000,000	0.73%	MMF	AAA	0.000%
Yellow	Up to 5 years	Insight MMF	170,000	0.72%	MMF	AAA	0.000%
		Total Investments	**8,170,000**	**0.74%**			**0.000%**

*Suggested maximum Investment duration