



INDEPENDENT AUDIT COMMITTEE - 17 JULY 2018

TREASURY MANAGEMENT OUTTURN 2017/18

REPORT BY ALEXIS GARLICK

PURPOSE OF THE REPORT

The purpose of this report is to present the 2017/18 treasury management outturn for Dorset, for comment prior to approval by the PCC.

1. Introduction

1.1. The Police and Crime Commissioner (PCC) has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the PCC to approve a treasury management annual report after the end of each financial year.

1.2. Treasury management in the context of this report is defined as:

"The management of the organisation'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."

1.3. This annual report sets out the performance of the treasury management function for 2017/18. 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.

1.4. With one exception, all treasury activity during 2017/18 has complied with the PCC's Treasury Management Strategy, Investment Strategy and Prudential indicators as well as all relevant statute, guidance and accounting standards. Appendix 1 provides the performance detail. The exception relates to the maturity structure of borrowing; the target did not allow for the existing PFI and loan debt which is longer than 10 years.

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2. Regulatory Changes

- 2.1. In December 2017, CIPFA published revised editions of the Treasury Management Code and the Prudential Code. The required changes are reflected in the 2018/19 Treasury Management Strategy.
 - 2.1.1. The 2017 Prudential Code introduces the requirement for a Capital Strategy to provide a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions. Work is in progress to consider the full implications of these changes.
 - 2.1.2. In the 2017 Treasury Management Code the definition of ‘investments’ has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is to be identified and reported.
- 2.2. In February 2018 the Ministry of Housing, Communities and Local Government (MHCLG) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).
 - 2.2.1. Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called “loans” (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan should yields on investments fall. This s unlikely to have a material impact on Dorset.
 - 2.2.2. The definition of prudent MRP has been changed to “put aside revenue over time to cover the CFR”; it cannot be a negative charge. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.
- 2.3. **MiFID II:** As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria were met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions to have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

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2.3.1. Dorset met the conditions to opt up to professional status and did so in order to maintain its MiFID II status from January 2018. This allows continued access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

3. External Context

3.1. In 2017/18 the UK economy showed signs of slowing, GDP grew by 1.8% in the calendar year, the same level as in 2016. Year-on-year CPI rose to 3.1% in November before falling back to 2.7% in February 2018. The Bank Base Rate increased by 0.25% in November 2017 to 0.5%. A fuller explanation of the 2017/18 external context, as provided by the Treasury Management Advisors Arlingclose Limited, is provided at Appendix 3.

4. Investment Activity

4.1. At 31 March 2018 Dorset had short term investments and cash equivalents of £9.9m, a decrease on 2017 of £6.6m. This reduction is reflective of the reduction in usable reserves during the year, utilised for the funding of capital expenditure and support for the revenue budget.

4.2. Funds are available for investment, representing income received in advance of expenditure plus balances and reserves. During 2017/18, Dorset's investment balance ranged between £3m and £33m million. The year-end investment position and the year-on-year change is show in appendix 1.

4.3. 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.

4.4. Investments are reviewed quarterly and benchmarked against other similar organisations by Arlingclose Ltd. The outturn benchmarking is provided at Appendix 2. This is used to inform the future investment strategy.

4.5. The collapse of Icelandic banks in 2008 leaves an outstanding balance of £40,701 out of a claim totalling £2,035,104 in respect of a temporary loan of £2m to Heritable Bank Ltd (now in administration). The latest Administrator's report, dated 19 March 2018, advises that a final distribution will not be made until the conclusion of claims from a subsidiary company in relation to intercompany loans. This is being progressed through the courts.

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. These factors and the year-on-year change are summarised in appendix 1.

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- 5.2. At 31 March 2018 Dorset's underlying need to borrow for capital purposes / CFR was £32.8m, £1.7m higher than the estimate in the Treasury Management Strategy for 2017/18. The reason for this is that CFR was increased by £2.2m at the end of 2016/17, against which a statutory Minimum Revenue Provision of £0.5m was made during 2017/18.
- 5.3. Most of the CFR at the year-end (£29.9m) 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 2018 was £6.4m. 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 2018 was £23.5m. Government grants are received annually towards the costs of these schemes.

6. Performance Report

- 6.1. The financial performance of treasury management activities are measured both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in Appendix 1.
- 6.2. Interest income receivable was marginally lower than budgeted mainly because of lower average balances than estimated.

Lucinda Hines
Head of Technical Accounting

Alexis Garlick
Chief Finance Officer for Dorset OPCC

COMPLIANCE REPORT

Compliance Report

With the exception of the maturity structure of borrowing >10yrs (where the indicator was incorrectly set), all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the approved Treasury Management Strategy. Compliance with specific investment limits, and the authorised limit and operational boundary for external debt is demonstrated in the indicators below.

Treasury Management Indicators

Exposures to treasury management risks are measured using the following indicators.

Security: The PCC has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk. The portfolio average credit rating for 2017/18 was A+.

Liquidity: The PCC has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling 31 days duration, without additional borrowing.

Interest Rate Exposures: This indicator is set to control exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as a percentage of net interest payable.

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.

Maturity Structure of Borrowing: This indicator is set to control the exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing are shown below.

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

The indicators show that all our long term liabilities fall into the category 10 years and above. There are in fact 3 long term liability arrangements in place maturing 2029, 2031 and 2034. Repayment schedules have been agreed for each loan period and the annual repayable amounts are factored in the MTFS each year. All 3 arrangements were in place prior to the TM strategy being set.

COMPLIANCE REPORT

Investment and Debt Portfolio Position

Dorset	31 st March 2017 Actual Portfolio £'000	31 st March 2018 Actual Portfolio £'000	Year on Year Change £'000
Total External Borrowing	0	0	0
Other Long-Term Liabilities:			
Private Finance Initiative	(31,586)	(29,885)	1,701
Other long term liabilities	(1,325)	(1,205)	120
Total Other Long-Term Liabilities	(32,911)	(31,090)	1,821
Total External Debt	(32,911)	(31,090)	1,821
Investments:			
Banks and building societies (unsecured)	11,558	7,333	(4,225)
Money Market Funds	4,925	2,600	(2,325)
Total Investments	16,483	9,933	(6,550)
Net Debt	(16,428)	(21,157)	(4,729)

Treasury Management Summary

Dorset	31.3.17 Balance £'000	2017/18 Movement £'000	31.3.18 Balance £'000	31.3.18 Average Rate %
Long-term borrowing	(32,911)	1,821	(31,090)	5.90
Total borrowing	(32,911)	1,821	(31,090)	
Short-term investments	5,500	(2,495)	3,005	0.40
Cash and cash equivalents	10,983	(4,055)	6,928	0.47
Total investments	16,483	(6,550)	9,933	
Net borrowing	(16,428)	(4,729)	(21,157)	

COMPLIANCE REPORT

Investment Position

Dorset	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Average Rate %
Banks & building societies	11,469	(5,500)	5,969	0.50
Money Market Funds	4,925	(2,325)	2,600	0.37
Total investments	16,394	(7,825)	8,569	

Investment Benchmarking

Dorset	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.12.2017	5.31	A+	100%	15	0.32%
31.03.2018	5.34	A+	100%	34	0.29%

*Weighted average maturity

Impact on Revenue

Dorset	Treasury mgmt. Strategy £'000	Actual £'000	Variance £'000
Interest Receipts	(100)	(88)	12
Cost of borrowing for capital investment	1,821	1,821	0
Minimum Revenue Provision	0	530	530
Total	1,721	2,263	542

COMPLIANCE REPORT

Investment Limits

Dorset	2017/18 Maximum	31.3.18 Actual Maximum	Complied
Any single organisation, except the UK Central Government	£6m each (£3m unsecured funds)	£3m unsecured funds	✓
Any group of organisations under the same ownership	£6m per group (£3m unsecured funds)	0	✓
Any group of pooled funds under the same management	£6m per manager	0	✓
Negotiable instruments held in a broker's nominee account	£12m per broker	0	✓
Foreign countries	£6m per country	0	✓
Registered Providers	£12m in total	0	✓
Unsecured investments with Building Societies	£6m in total	0	✓
Money Market Funds	£18m in total	£2.6m in total	✓

External Debt and Other long Term Liabilities

Dorset	2017/18 £'000	31.3.18 Actual £'000	2017/18 Operational Boundary £'000	2017/18 Authorised Limit £'000	Complied
Borrowing	0	0	36,092	44,092	✓
PFI & Pre 90 Loan	31,092	31,090			✓
Total debt	31,092	31,090	36,092	44,092	✓

COMPLIANCE REPORT

Treasury Management Indicators: Liquidity

OPCC for Dorset	2017/18 Target	31.3.18 Actual	Complied
Total cash available within 31 days	£12m	£12m	✓
Total sum borrowed in past 31 days without prior notice	0	0	✓

Treasury Management Indicators: Interest Rate Exposure

OPCC for Dorset	2017/18 Target	31.3.18 Actual	Complied
Upper limit on fixed interest rate exposure	£200k	£200k	✓
Upper limit on variable interest rate exposure	£100k	£100k	✓

Maturity Structure of Borrowing

OPCC for Dorset	31.3.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0%	25%	0%	✓
12 months and within 24 months	0%	25%	0%	✓
24 months and within 5 years	0%	25%	0%	✓
5 years and within 10 years	0%	35%	0%	✓
10 years and above	100%	45%	0%	X

Note: the Treasury indicators that were set for the maturity structure of borrowing in 2017/18 did not allow for the existing PFI and pre 1990 inherited debt. This has been corrected in the Treasury Management Strategy for 2018/19.

COMPLIANCE REPORT

Prudential Indicators

Capital Expenditure

Estimates of Capital Expenditure: The actual capital expenditure and financing is shown in the table below.

Capital Expenditure and Financing	2017/18 Treasury Management Strategy £'000	2017/18 Actual £'000	Variance Higher / (lower) £'000
Total Expenditure	3,220	3,162	(58)
Capital Receipts	2,146	2,740	594
Government Grants	474	422	(52)
Revenue contribution to capital	600	0	(600)
Total Financing	3,220	3,162	(58)

Capital Financing Requirement

Estimates of Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the underlying need to borrow for a capital purpose.

Capital Financing Requirement	2017/18 Treasury Management Strategy £'000	2017/18 Actual £'000	Variance Higher / (lower) £'000
Opening CFR	32,913	35,132	2,219
Less: Minimum Revenue Provision	0	(530)	(530)
Less: PFI and debt repayments	(1,821)	(1,821)	
Closing CFR	31,092	32,781	1,689



Investment Benchmarking

31 March 2018

Dorset Police
12 Police & Fire Authorities Average
135 LAs Average

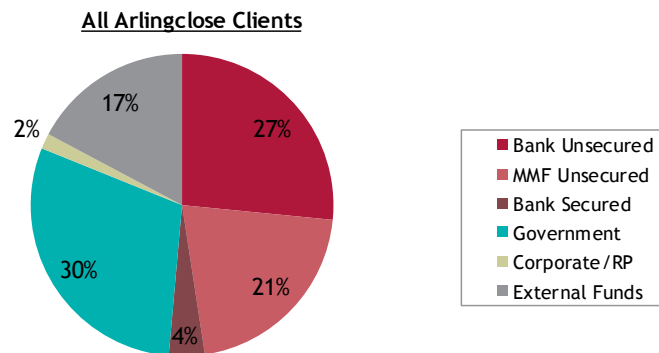
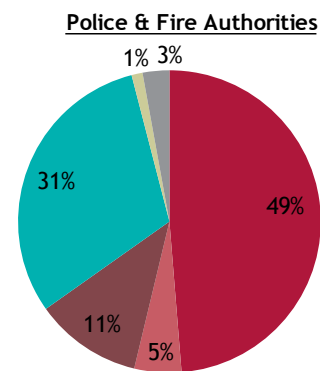
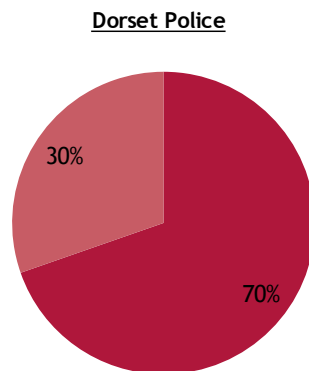
Internal Investments	£8.6m	£18.9m	£57.1m
External Funds	£0.0m	£0.9m	£10.2m
TOTAL INVESTMENTS	£8.6m	£19.9m	£67.4m

Security			
Average Credit Score	5.70	4.11	4.24
Average Credit Rating	A	AA-	AA-
Average Credit Score (time-weighted)	5.34	3.81	4.03
Average Credit Rating (time-weighted)	A+	AA-	AA-
Number of Counterparties / Funds	3	9	15
Proportion Exposed to Bail-in	100%	55%	55%

Liquidity			
Proportion Available within 7 days	65%	51%	42%
Proportion Available within 100 days	100%	81%	69%
Average Days to Maturity	34	90	35

Market Risks			
Average Days to Next Rate Reset	48	70	58
External Fund Volatility	0.0%	0.8%	2.1%

Yield			
Internal Investment Return	0.29%	0.50%	0.63%
External Funds - Income Return		3.39%	3.22%
External Funds - Capital Gains/Losses		0.86%	0.19%
External Funds - Total Return		4.24%	3.41%
Total Investments - Income Return	0.29%	0.58%	1.05%
Total Investments - Total Return	0.29%	0.61%	1.08%



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.

EXTERNAL CONTEXT PROVIDED BY ARLINGCLOSE (reflecting the data as at 9 April 2018)

Economic commentary

2017/18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now span Q2 2019 to Q4 2020. The Withdrawal Treaty is yet to be ratified by the UK parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February Inflation Report indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

EXTERNAL CONTEXT PROVIDED BY ARLINGCLOSE (reflecting the data as at 9 April 2018)

Financial markets: The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

Credit background:Credit Metrics

In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the OPCC would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non-ring-fenced entities would actually look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non-ring-fenced bank.

Money Market Fund regulation: The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

EXTERNAL CONTEXT PROVIDED BY ARLINGCLOSE (reflecting the data as at 9 April 2018)Credit Rating developments

The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

Moody's downgraded Rabobank's long-term rating due to its view on the bank's profitability and the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors. S&P also upgraded the long-term rating of ING Bank to A+.

Other developments:

In February, Arlingclose advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following Arlingclose's advice, no investments in RBS plc and National Westminster Bank were considered. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be considered.