**Appendix 1**

Police and Crime Commissioner
CAMBRIDGESHIRE AND PETERBOROUGH

# Strategy Statement and Annual Investment Strategy

## Mid-year Review Report

Cambridgeshire Police And Crime Commissioner
2018/19

# Table of Contents

# 1 Background

## 1.1 Treasury Management

The Police and Crime Commissioner (the Commissioner) operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Commissioner's capital plans. These capital plans provide a guide to the borrowing need of the Commissioner, essentially the longer term cash flow planning to ensure the Commissioner can meet the capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet the Commissioner's risk or cost objectives.

Accordingly, treasury management is defined as:

> "The management of the local authority's borrowing, 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."

## 1.2 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

A report setting out our Capital Strategy will be provided to the Commissioner before 31st March 2019.

# 2 Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Commissioner's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Commissioner will seek to achieve those policies and objectives.
3. Receipt by the Commissioner of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a

Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

4. Delegation by the Commissioner of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Commissioner of the role of scrutiny of treasury management strategy and policies to a specific named body. The named body delegated by the Commissioner is the Finance Sub Group with reports subsequently being presented to the Joint Audit Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2018/19 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Commissioner's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Commissioner's investment portfolio for 2018/19;
- A review of the Commissioner's borrowing strategy for 2018/19;
- A review of any debt rescheduling undertaken during 2018/19;
- A review of compliance with Treasury and Prudential Limits for 2018/19.

Recommendations

The Business Co-ordination Board is asked to recommend to note the report and the treasury activity.

# 3 Economics and interest rates

## 3.1 Economics update

**UK**

The first half of 2018/19 has seen UK **economic growth** post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the **labour market,** unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA**

President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

**EUROZONE**

Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

**CHINA**

Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

**JAPAN**

Japan has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

## 3.2 Interest rate forecasts

The Commissioner's treasury advisor, Link Asset Services, has provided the following forecast:

| Link Asset Services Interest Rate View | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 |
| Bank Rate View | 0.75% | 0.75% | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.50% | 1.50% |
| 3 Month LIBID | 0.75% | 0.80% | 0.80% | 0.90% | 1.10% | 1.10% | 1.20% | 1.40% | 1.50% | 1.60% | 1.60% |
| 6 Month LIBID | 0.85% | 0.90% | 0.90% | 1.00% | 1.20% | 1.20% | 1.30% | 1.50% | 1.60% | 1.70% | 1.70% |
| 12 Month LIBID | 1.00% | 1.00% | 1.00% | 1.10% | 1.30% | 1.30% | 1.40% | 1.60% | 1.70% | 1.80% | 1.80% |
| 5yr PWLB Rate | 2.00% | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% |
| 10yr PWLB Rate | 2.40% | 2.50% | 2.50% | 2.60% | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% |
| 25yr PWLB Rate | 2.80% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.50% | 3.50% |
| 50yr PWLB Rate | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% |

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The balance of risks to the UK:

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially

holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.

- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates:

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

# 4 Treasury Management and Annual Investment Strategy Update

There are no policy changes to the Treasury Management Strategy Statement (TMSS) for 2018/19; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

| **Prudential Indicator** | **2018/19 Original £m** | **2018/19 Revised £m** |
|---|---|---|
| Authorised Limit | 23.5 | 23.5 |
| Operational Boundary | 20.5 | 20.5 |
| Capital Financing Requirement | 21.2 | 21.2 |

# 5 The Commissioner's Capital Position (Prudential Indicators)

## 5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

| All figures £m | Approved B/Fwd from 2017-18 | Original 2018/19 Capital Programme | Total Programme | **Revised 2018/19 Capital Budget** | Actual & Committed Ytd | Forecast Spend 2018/19 |
|---|---|---|---|---|---|---|
| **Capital Payments:-** | | | | | | |
| Land & Buildings | 0.8 | 4.0 | 4.8 | **1.8** | 0.8 | **1.3** |
| IT & Communications | 0.9 | 1.2 | 2.1 | **2.3** | 2.1 | **2.6** |
| Fleet | 0.4 | 1.7 | 2.1 | **2.1** | 0.9 | **2.1** |
| Other Equipment & Collaboration | 0.1 | 0.2 | 0.3 | **0.4** | 0.3 | **0.4** |
| Schemes approved subject to further business case | - | 0.4 | 0.4 | **0.1** | - | **-** |
| **TOTAL** | 2.2 | 7.5 | 9.7 | **6.7** | 4.1 | **6.4** |

The original approved Capital Programme has been reduced by £2.9m (£3.4m in relation to Parkside land purchase to be moved into 2019/20 and £0.5m added due mainly from Estate Requirements). Budget of £0.8m is proposed to carry forward to 2019/20 which will leave us with an overspend of £0.5m.

## 5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Commissioner by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

| All figures £m | B/Fwd from previous years | Original 2018/19 Capital Programme | Previously Authorised Programme Amendments | **Revised 2018/19 Capital Budget** |
|---|---|---|---|---|
| **Capital Financing:-** | | | | |
| Capital Grants | 0.2 | 0.5 | 0.2 | **0.8** |
| ESMCP Grant (RCCO) | - | 0.2 | 0.0 | **0.2** |
| Carry Forward Reserve | 2.0 | - | -0.0 | **2.0** |
| ICT | - | 0.2 | - | **0.2** |
| Capital Reserves | - | 1.0 | 0.1 | **1.1** |
| Capital Receipts | - | 1.9 | 0.4 | **2.3** |
| Vehicle Receipts (RCCO) | - | 0.2 | -0.2 | **-** |
| Borrowing | - | 3.4 | -3.4 | **0.1** |
| **TOTAL** | 2.2 | 7.4 | -2.9 | **6.7** |

## 5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR) and External Debt

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period.

We are on target to achieve the original forecast Capital Financing Requirement.

| Capital Financing Requirement and External Debt | 2018/19 Original Estimate £m | 2018/19 Current Position £m | 2018/19 Revised Estimate £m |
|---|---|---|---|
| **Total CFR** | 21.2 | 21.9 | 21.2 |
| **Net movement in CFR** | **(0.8)** | **0.00** | **(0.8)** |
| | | | |
| Borrowing | 18.4 | 18.6 | 18.4 |
| Other long term liabilities* | 0.0 | 0.0 | 0.0 |
| **Total debt (year end position)** | **18.4** | **18.6** | **18.4** |

** Includes finance leases*

## 5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose*. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Commissioner has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

** The management of transferred debt should be excluded from net borrowing.*

| Operational Boundary for external debt | 2018/19 Original Estimate £m | 2018/19 Revised Estimate £m |
|---|---|---|
| Borrowing | 20.5 | 20.5 |
| Other long term liabilities* | 0.0 | 0.0 |
| **Total debt** | **20.5** | **20.5** |
| **CFR* (year end position)** | **21.2** | **21.2** |

** Includes finance leases*

The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

| Authorised limit for external debt | 2018/19 Original Indicator £m | 2018/19 Revised Indicator £m |
|---|---|---|
| Borrowing | 23.5 | 23.5 |
| Other long term liabilities* | 0.0 | 0.0 |
| **Total** | **23.5** | **23.5** |

** Includes on balance sheet PFI schemes and finance leases etc.*

# 6 Investment Portfolio

In accordance with the Code, it is the Commissioner's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Commissioner's risk appetite. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Commissioner held £22.6m of investments as at 30 September 2018 (£16.1m at 31 March 2018) and the investment portfolio yield for the year to date is 0.72% against a benchmark (overnight LIBOR -.25%) of 0.29%.

The Commissioner's budgeted investment return for 2018/19 is £114,000, and performance for the year to date is £14,300 below budget. However, with fixed term deposits maturing in the latter part of 2018/19, the investment return for the full year will exceed budget.

Investment Counterparty criteria
The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function therefore there are no proposed changes at this point.

# 7 Borrowing

The Commissioner's capital financing requirement (CFR) for 2018/19 is £21.2m. The CFR denotes the Commissioner's underlying need to borrow for capital purposes. If the CFR is positive the Commissioner may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.3 shows the Commissioner has borrowings, including finance leases, of £18.4m and is under-borrowed by £2.8m. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

Whilst there is an underlying need to borrow for capital purposes, it is anticipated that further borrowing will not be undertaken during this financial year.

# 8 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

# 9 Other

## 9.1 UK banks – ring fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

## 9.2 IFRS9 accounting standard

This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted. The impact for the Commissioner is likely to be negligible.

The Ministry of Housing, Communities and Local Government (MHCLG), are currently conducting a consultation for a temporary override to allow English local authorities time to adjust their portfolio of investments. Members will be updated when the result of this consultation is known.