

TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

07 October 2013

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT MID-YEAR REVIEW 2013/14

This report provides an update on treasury management activity undertaken during the period April to August of the current financial year. Members are reminded of the parameters that define the Council's risk appetite and of the arrangements for managing the Council's investments. Members are invited to endorse the action taken by officers in respect of treasury management activity to date and to retain the current risk parameters and management arrangements.

1.1 Introduction

1.1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 18 February 2010.

1.1.2 The primary requirements of the 2009 Code and its subsequent revisions are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report (this report) and an Annual Report (stewardship report) covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

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

- An economic update and revised interest rate forecast.
- Investment performance for the period April to August of the 2013/14 financial year and the current investment portfolio.
- Borrowing.
- Compliance with Treasury and Prudential Limits for 2013/14.
- A review of the risk parameters and arrangements for managing the Council's investments contained in the 2013/14 Treasury Management Strategy Statement and Annual Investment Strategy (2013/14 Investment Strategies).

1.2 Economic Background

- 1.2.1 During 2013/14 economic indicators suggested that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter of 2013, with a 0.3% quarterly expansion the economy grew 0.7% in the second quarter. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations.
- 1.2.2 The strengthening in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment further. Pay growth also rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.3% year on year, well below the rate of inflation, providing continuing pressure on household's disposable income.
- 1.2.3 The Bank of England extended its 'Funding for Lending' scheme into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling to new lows. Together with the Government's 'Help to Buy' scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks have risen as have house prices, although they are still well below 2008 levels.
- 1.2.4 Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in the second quarter looked to be broadly in line with last year's figures, highlighting the government's difficulty in reducing borrowing while economic growth was relatively lacklustre. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving. The Bank Rate remains at 0.5% and quantitative easing also stayed at £375bn. In August, the MPC provided 'forward guidance' that the Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC would review the Bank Rate,

not necessarily take action to change it. The June three month average unemployment rate was 7.8% and the more volatile one month rate 7.4%.

- 1.2.5 The Consumer Price Index (CPI) fell marginally to 2.7% in August. The Bank of England expects CPI to fall back to 2.0% (target rate) in 2015.
- 1.2.6 In June, financial markets sold off following a Federal Reserve (Fed) statement that suggested the US central bank may ‘taper’ its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK. Equity prices fell too; initially as Fed purchasing of bonds has served to underpin investor moves into equities out of low yielding bonds. However, as the market moves to realign its expectations, bond yields and equities are likely to rise further.
- 1.2.7 Tensions in the Euro-zone eased over the second quarter but a number of triggers for a potential flare-up remain. Economic survey data improved consistently over the first half of the year and a return to growth in the second quarter ended six quarters of Euro-zone recession.
- 1.2.8 **Sector’s interest rate forecast.** Sector, the Council’s external treasury advisor, updated their interest rate forecast in August 2013. The first rise in Bank Rate, which has remained at an emergency level of 0.5% for over four years, is now expected to occur in the final quarter of 2016. This is some 21 months later than predicted when our current 2013/14 Investment Strategies were approved in February 2013.
- 1.2.9 The update was prepared following the release of the Bank of England’s August 2013 inflation report and the introduction by them of ‘forward guidance’. The ‘forward guidance’ is intended to make the Bank’s existing stimulus programme more effective by providing greater clarity to households and businesses. The guidance was issued with the emphatic message that the financial markets were wrong in their expectation of an earlier increase in the Bank Rate. On the back of recent positive economic data some forecasters still predict an earlier (late 2014) Bank Rate rise will be necessary to contain inflationary pressures.

Rate	Now	Dec-2013	Mar-2014	Jun-2014	Sep-2014	Dec-2014	Mar-2015	Jun-2015	Sep-2015	Dec-2015	Mar-2016	Jun-2016
	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3mth LIBID	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.50
12mth LIBID	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.90	1.00	1.20	1.40
5yr PWLB	2.20	2.20	2.20	2.20	2.20	2.30	2.40	2.50	2.60	2.80	2.90	3.00
10Yr PWLB	3.30	3.30	3.30	3.30	3.30	3.40	3.50	3.60	3.80	3.90	4.10	4.20
25yr PWLB	4.20	4.20	4.30	4.30	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.00
50yr PWLB	4.30	4.30	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.10

1.3 Investment Portfolio

- 1.3.1 In accordance with the CIPFA Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 1.2, it is a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate and suppressed further by the 'Funding for Lending' scheme.
- 1.3.2 A full list of investments held on 30 August 2013 and our Internal Lending List of the same date are shown in **[Annexes 1 and 2]** of this report.
- 1.3.3 The average level of cash flow funds available for investment purposes to the end of August 2012 was £10.9m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. At the end of August the authority held £15.4m of core cash balances for investment purposes which are managed by our external fund manager. These funds are for the most part available to invest for more than one year, albeit a proportion will need to be recalled towards the end of the financial year to top-up our daily cash balances.
- 1.3.4 As at the end of August 2013 funds invested and interest earned is set out in the table below:

	Funds invested at 31 Aug 2013 £m	Average duration to maturity Yrs	Weighted average rate of return %	Interest earned to 31 Aug 2013 £	Gross annualised return to 31 Aug 2013 %	7 day Libid benchmark %
In-house cash flow excluding Landsbanki	8.0	0.20	0.76	30,000	0.65	0.41
Externally managed core funds	15.4	0.88	0.64	36,100	0.56	0.41
Total	23.4	0.64	0.68	66,100	0.60	0.41

- 1.3.5 Whilst the authority achieved its benchmark return, interest earned of £66,100 is £32,000 lower than our profiled budget for the same period. This underperformance against budget is attributed to the lower than expected return delivered by our external fund manager and is explored in more detail in paragraphs 1.3.9 and 1.3.10.
- 1.3.6 **In-house managed cash flow.** Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations.

However, when cash surpluses permit, fixed term investments are made to take advantage of the higher yields available. Thus far in this financial year the following fixed term investments have been made:

£m	Bank/Building Society	Duration	Rate	Period
1.0	Bank of Scotland	12 Months	1.10%	12/4/13 – 11/4/14
1.0	Lloyds TSB	12 Months	1.10%	12/4/13 – 11/4/14
0.6	Lloyds TSB	11 Months	1.05%	12/4/13 – 11/3/14

- 1.3.7 In addition to term deposits the opportunity to generate additional yield is also achieved by utilising notice accounts. At 31 August 2013, £1.75m was deposited in a National Westminster 95 day notice account at a rate of 0.80% per annum and £1.0m deposited in a 35 day notice account with Barclays at 0.54% per annum.
- 1.3.8 The Council achieved a return of 0.65% on its in-house managed cash flow investments for the period ended August 2013, compared to a 7-day LIBID benchmark of 0.41%. Investment income achieved for the period ended August 2013 is broadly in line with budget at £30,000.
- 1.3.9 **Externally managed core funds.** In accordance with our 2013/14 Investment Strategies all of the Council's core funds are being managed by our external fund manager. The Council's fund manager achieved a gross return of 0.56% for the period ended August 2013, compared to a 7-day LIBID benchmark of 0.41%. Excluding unrealised losses on recent UK Gilt purchases of £46,000, investment income achieved for the period ended August 2013 is £36,100.
- 1.3.10 At the end of August 2013 the value of the fund stood at £15.4m. This was invested at an average rate of 0.64% and an average maturity of 0.88 years. The fund manager lowered their expected return for the year to 0.90% at our meeting with them in March. This return implies a shortfall against budget provision for externally managed funds of £20,000 for the year as a whole. However, given the return thus far, a more substantive shortfall can be anticipated. A return for the year of 0.60% (average of the return to date of 0.56% and current yield of 0.64%) implies a shortfall against budget of some £62,000. If the unrealised losses on Gilts are not reversed over the coming months these will also need to be incorporated into our year end Statement of Accounts and thus increase the shortfall against budget.

1.4 Borrowing

- 1.4.1 It is a statutory duty for the Council to determine and keep under review the 'Affordable Borrowing Limits' by way of the Prudential Indicators (affordability limits) set out in the approved 2013/14 Investment Strategies. The authority is debt free and uses a combination of reserves and revenue contributions to finance the Capital Plan. Borrowing on a temporary basis using overdraft facilities may be required from time to time to meet liquidity needs. No borrowing was undertaken in the period April 2013 to August 2013.

1.5 Compliance with 2013/14 Investment Strategies

- 1.5.1 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the 2013/14 Investment Strategies and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found at **[Annex 3]** to this report.
- 1.5.2 Throughout the period April 2013 to August 2013 all of the requirements contained in the 2013/14 Investment Strategies intended to limit the Council's exposure to investment risks (minimum sovereign and counterparty credit rating; durational limits; exposure limits in respect of counterparties, groups of related counterparty and sovereigns; and specified and non-specified investment limits) have been fully complied with.

1.6 Review of the risk parameters and management arrangements contained within the 2013/14 Investment Strategies

- 1.6.1 Members will recall the detailed consideration that was given to the 2013/14 Investment Strategies at the January 2013 meeting of the Audit Committee. The strategies include the detailed parameters that aim to limit the Council's exposure to investment risks. The strategies also set out the management responsibility for those investments (in-house or external fund manager).
- 1.6.2 **Risk constraints.** The Council limits its exposure to counterparty risk by only investing in banks and other financial institutions with a high credit rating and requires investments to be diversified across a range of counterparties. More specifically the 2013/14 Investment Strategies require:
- Counterparties must be regulated by a Sovereign rated AA- or better as recognised by each of the three main rating agencies (Fitch, Moody's or Standard & Poor's).
 - Whilst 100% of funds can be invested in the UK, exposure to non-UK banks is limited to no more than 20% of funds per Sovereign.
 - Counterparties must have a minimum Fitch rating of: long term A, short term F1, viability bbb- and support 1.
 - Exposure to individual counterparties / groups of related counterparty must not exceed 20% of funds (25% of funds for part state owned UK Banks).
 - Duration of In-house managed investments must not exceed that recommended by Sector's credit worthiness approach (modelling approach which combines the output from all three rating agencies including credit watches / outlooks and Credit Default Swap data).
 - Money Market funds should be rated Fitch AAmmf or equivalent and exposure limited to no more that 20% per fund.
- 1.6.3 The 2013/14 Investment Strategies also limit the type of instrument (e.g. term deposits, floating rate notes etc.) that can be used and establishes a maximum investment duration (2 years other than Gilts). Given our overriding investment priorities of security of capital and liquidity the Council does not invest in equities.

- 1.6.4 **In preparing this report our risk parameters have been reviewed and no changes are proposed.**
- 1.6.5 **Management arrangements.** The Council splits the funds available for investment into two categories, core funds and cash flow funds. Core funds comprise the Council's revenue and capital reserves which are used to support the Council's spending plans over a number of years. Cash flow funds are monies consumed during the course of a financial year and arise from timing differences between the receipt of income (business rates, council tax, grants and other sources of income) and its subsequent expenditure (payments to government, precepting authorities, staff and suppliers).
- 1.6.6 The 2013/14 Investment Strategies requires that all core funds are managed by our external fund manager. Cash flow funds that are available for more than three months should also be passed to the external fund manager unless a better return can be achieved via in-house investment. In each of the last three years, in-house investment has been the preferred option for investing such surpluses.
- 1.6.7 In 1991 the Council sold its stock of council houses. The sale proceeds enabled the Council to repay all borrowing and the balance (over £50m) has been used ever since to fund the Council's capital expenditure plans and provide an income stream from investments to support the revenue budget. Some £8m of sale proceeds remains today and forms part of the core funds managed by our external fund manager. The core funds balance is currently £15.4m of which approximately £3m is expected to be used this financial year to support the Council's revenue budget and capital expenditure plans. A similar drawdown can be anticipated in subsequent years until the Council achieves a balanced budget.
- 1.6.8 Members are invited to **retain the present management arrangements for the remainder of this financial year.** However, given the dwindling resource available for external management, consideration of alternative arrangements is now appropriate. This issue will be presented in more detail as part of next financial year's investment strategy report to Audit Committee in January 2014.

1.7 Legal Implications

- 1.7.1 The Council invested £1m in a three month fixed term deposit with the Icelandic bank, Landsbanki. The bank went into administration a few days prior to the investments intended maturity in October 2008. The Council has participated in a joint action, co-ordinated by the Local Government Association, to recover the investment and associated interest. To date the Council has received £542,700 in partial payments from the Landsbanki Winding-up Board. A separate report in Part 2 of the agenda provides further detail on current recovery action.

1.8 Financial and Value for Money Considerations

1.8.1 Interest earned to the end of August 2013 of £66,100 is £32,000 below that anticipated in our original estimates for 2013/14. The 'Funding for Lending' scheme introduced by the Bank of England to facilitate economic recovery has had a significant impact on bank funding costs resulting in much lower than expected investment returns. The scheme is expected to be in place until January 2015. This initiative together with an expectation that the Bank Rate will remain at the present level of 0.5% until late 2016 generates little prospect of investment returns improving in the second half of the financial year. A shortfall against budget of the order of £60,000 - 70,000 is increasingly likely.

1.9 Risk Assessment

1.9.1 The application of best practice, including the regular reporting and scrutiny of treasury management activity, as identified by the CIPFA Code is considered to be the most effective way of mitigating the risks associated with treasury management.

1.10 Equality Impact Assessment

1.10.1 See 'Screening for equality impacts' table at the end of this report.

1.11 Recommendations

1.11.1 Members are invited to **RECOMMEND** that Cabinet:

- 1) Endorse the action taken by officers in respect of treasury management activity for the period April to August 2013.
- 2) Retain the parameters intended to limit the Council's exposure to investment risks and retain the management arrangements as set out in the 2013/14 Investment Strategies.

Background papers:

contact: Mike Withey

Nil

Sharon Shelton
Director of Finance and Transformation

Screening for equality impacts:		
Question	Answer	Explanation of impacts
a. Does the decision being made or recommended through this paper have potential to cause adverse impact or discriminate against	No	N/A

Screening for equality impacts:		
Question	Answer	Explanation of impacts
different groups in the community?		
b. Does the decision being made or recommended through this paper make a positive contribution to promoting equality?	No	N/A
c. What steps are you taking to mitigate, reduce, avoid or minimise the impacts identified above?		N/A

In submitting this report, the Chief Officer doing so is confirming that they have given due regard to the equality impacts of the decision being considered, as noted in the table above.