TONBRIDGE & MALLING BOROUGH COUNCIL

CABINET

06 September 2006

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Council

1 REVIEW OF THE COUNCIL'S TREASURY MANAGEMENT STRATEGY STATEMENT AND INVESTMENT STRATEGY FOR 2006/07

This report identifies changes that would enhance the combined strategy for 2006/07 and addresses the issue of poor returns achieved by the Council's External Fund Manager during the first quarter of the financial year.

1.1 Introduction

1.1.1 At the meeting of the Finance & Property Advisory Board on 12 July 2006, Members expressed understandable concern in relation to the adverse effect on the revenue budget of the performance of the externally managed funds.

1.1.2 Members were reassured that the concerns were shared by your officer team and were advised that a review was being undertaken with the Council's independent Treasury Advisers to determine whether a change in investment strategy and external fund manager was required.

1.1.3 This report addresses those issues as well as the Advisory Board's request that a full report updating the position was presented to this meeting of Cabinet.

1.2 Treasury Advisers

1.2.1 At the meeting of the Finance & Property Advisory Board on 10 May 2006, Members agreed to the re-appointment of the Council's Treasury Adviser at an enhanced service level following a joint procurement exercise with other Kent authorities (minute FP 06/060). Whilst it was not envisaged that the new contract would come into play until November 2006, concerns about investment performance led me to bring the contract start date forward – funded from existing budgets – and the Treasury Adviser commenced the new contract at the beginning of July.

1.2.2 My staff and I have been working closely with our Treasury Adviser since their appointment and in particular had asked that they undertake two specific exercises.

1.2.3 The first of these was essentially one of providing **reassurance on technical and compliance issues in respect of our balance sheet, funding requirements and treasury management**.

1.2.4 Their second exercise was to provide **feedback on the performance of our external fund manager** against their peers and to offer advice on the alternatives open to us.

1.3 Compliance and Strategy

1.3.1 In respect of the compliance, balance sheet and funding exercise, I am pleased to report that the Treasury Advisers were completely supportive of the approaches that we had taken and were only able to offer limited advice on what options might be open to us in the future, were our financial position to change significantly.

1.3.2 In respect of treasury management, the response from the Treasury Adviser was again positive and no specific changes to our policy or strategy were recommended.

1.3.3 However, when we met with the Treasury Adviser to discuss their findings it became apparent that our Treasury Management Strategy Statement and Annual Investment Strategy for 2006/07, approved by Council in February 2006 - a copy of which is reproduced at **[Annex 1]** - could provide for greater flexibility and diversity of risk if simple changes were made to the Investment Strategy element and to the list of Approved Non-Specified Investments.

1.3.4 Essentially, these changes could remove restrictions which currently preclude our in-house investment team from taking a longer view when seeking to enhance and provide greater certainty of return were they to invest beyond one year.

1.3.5 Since that meeting, further discussions have taken place with the Treasury Adviser and it is now suggested that if paragraphs 10.20 and 10.22 of the Investment Strategy were to be reworded as shown below, this would meet the needs identified above:

- The Council's in-house managed funds will be invested having regard to the core balance and cash flow requirements in those markets, instruments and limits set out at Appendix 3 Approved Specified Investments and Appendix 4 Approved Non-Specified Investments.

- Trigger rates for lending of one year or more will be obtained from and kept updated via the Council's Treasury Adviser. Such investments must be specifically approved by the Director of Finance or the Chief Accountant.

- It is proposed that two changes be made to the list of Approved Non-Specified Investments. These are:

1. The addition of a new category, Term and Callable Deposits with Banks and Building Societies. This change would allow both the in-house team and the external fund manager to invest in term and callable deposits with banks and building societies with maturities of more than one year when this type of invest provides the optimum mix of certainty and return.

2. The lowering of the minimum credit rating for Certificates of Deposit from F1 to AA- . This change should provide an opportunity for our external fund manager to gain a greater return without a commensurate increase in counter party risk. Also as CDs are negotiable and liquid, they can therefore be readily bought and sold if credit quality becomes an issue.

1.3.6 The changes above are shown in detail on an updated version of the Approved Non-Specified Investments Appendix at **[Annex 2].** As this is a complex technical matter, I should be grateful if Members could **raise any queries with the Exchequer Services Manager (John Pickup 6112) in advance of the meeting.**

1.3.7 Cabinet is accordingly invited at the conclusion of this report to recommend the above amendments to the Treasury Management Strategy Statement and Annual Investment Strategy for 2006/07 and the Approved Non-Specified Investments Appendix thereto, to Full Council.

1.4 External Fund Management

1.4.1 It is worth noting that the changes proposed above are not directly connected with the recent performance of our external fund manager, and do not presuppose a change in Council policy. If approved by Members, the changes outlined above would simply allow our in-house team to take a more active role, if Members so decided.

1.4.2 In respect of the recent poor performance by our fund manager, it is perhaps worth considering the vagaries of the cash fund market and looking back at the reasons behind our taking a longer view than year-to-year performance.

1.4.3 Since their appointment, albeit under another name, in July 1996 our fund manager managed to achieve top quartile performance for six out of the first seven years (achieving median quartile performance in the remaining year).

1.4.4 During that time they were by far the best performing fund manager and their standing was such that they attracted around one hundred and fifty authorities to their client list. Their run of good performances came to an end in 2003/04 when a precipitous collapse in the gilts market dragged down the return of ‘all duration’ based managers. In 2004/05, they managed to achieve top quartile performance again, but suffered a reverse in the last quarter of 2005/06 and in the first quarter of 2006/07, this because of a timing failure in the selling of gilt holdings.

1.4.5 Despite these reverses, our fund manager has on a 'since inception' basis exceeded the target 7 day LIBID bench mark by some 45 basis points, which in cash terms equates to a benefit of around £1.5m net of fees. Whilst this measure of out-performance or added value is impressive, it is acknowledged that the level of out-performance would have been higher but for the reverses referred to above.

1.4.6 At the meeting of Finance & Property Advisory Board on 12 July, Members were advised of the measures that have been taken by our fund manager to correct the deficiencies within their organisation and of their (and my) expectation that these measures **must bear fruit** in terms of the return that must be achieved for this year.

1.4.7 Notwithstanding the eventual return for this year, I have been considering what other fund management options are capable of delivering a return consistent with the expectations of our Medium Term Financial Strategy and our Treasury Adviser.

1.4.8 The principal options discussed with our Treasury Adviser were:

- A change of fund manager;
- Bringing back all funds in-house; and
- Bringing back a proportion of funds in-house.

Change of External Fund Manager?

1.4.9 The first of these, a change in fund manager, would require a tendering exercise to be undertaken in accordance with the Council's Contract Procedure Rules and possibly EU Procurement Rules. If the contract value multiplied by the term came to more than £150,000 then the latter Rules would come into play.

1.4.10 The shortest practicable timescale for re-letting the contract would be if the EU Procurement rules did not apply and, according to our Treasury Adviser, this could be "fast-tracked" to a two month timescale. In order to meet the "fast-track" timescale, we would almost certainly need to employ our Advisers as consultants at an unbudgeted cost of around £4,000. (If EU Procurement Rules were to apply, the process could extend to approximately six months).

1.4.11 I understand that the Treasury Adviser has model contract documentation and specifications available which can readily be modified for our requirements. My staff will be reviewing those model documents with the Adviser to ensure we are **ready to move** on a "fast-track" basis should the need arise.

1.4.12 Members will appreciate that whilst a change of fund manager would be expected to generate improved returns in the longer term, there **is no guarantee that they would out-perform the running yield of 5.07% currently being achieved**.

1.4.13 Our Treasury Adviser has pointed out that, at this juncture in the economic cycle, a 'duration based' fund manager such as ours should perform well and, therefore,

a change at this point carries a risk of lower returns in the short term. It is perhaps worth noting that this was indeed the case when we changed fund managers in the first half of the 1990's.

1.4.14 Over the years, Members have (rightly in my view) accepted the argument that investment returns must be viewed over a longer term period due to the inevitable peaks and troughs in this market. This has worked to our advantage in generating added value for eight out of ten years since 1996.

1.4.15 However, now that there is the potential for lower quartile performance in two consecutive years I do, naturally, recognise Members' concerns about the recent performance of this particular fund manager; despite advice that this may not be the best point in time to make a change.

1.4.16 It goes without saying that my staff and our Treasury Adviser are monitoring the position very closely indeed, and our fund manager is well aware of the attention that is being focused in his direction by Members and officers alike. I have met with the fund manager again since the F&PAB meeting, and I understand that the measures already taken to rectify the position are being strictly reinforced.

1.4.17 With all that in mind, Members may feel it is appropriate to set a 'target' to be achieved at the end of the financial year. I would suggest that the attainment of **at least median performance**, as measured by our Treasury Adviser, is a reasonable target to set. Of course, at any stage it will be within our gift to make a decision about the continuation of the contract, but this will at least provide a useful and serious focus for both the fund managers and ourselves.

Internal Fund Management

1.4.18 As I am sure Members will appreciate, bringing all of our funds back in-house has resource and training implications in that the in-house team would need to expand their market based skill levels significantly and to spend more time proactively managing investments. That said, it is not quite the issue that it was when we first acquired funds from the sale of the housing stock, principally because of the level of expertise acquired in the Service, through experience, has increased since that point.

1.4.19 However, there are a number of other risks inherent in this option, principally our reliance on a single officer, my Exchequer Services Manager, to play the key role and a restriction on the range of investment options open to us. Essentially these would be fixed and/or callable deposits in the absence of custodial services with, what could be, a serious 'downside' i.e. the absence of cash liquidity.

Mix of External and Internal Fund Management

1.4.20 Our Treasury Adviser recognised the difficulties that the first two options present and was, not surprisingly, supportive of a mix of internal and external fund management.

1.4.21 The benefits of such an approach were identified as:

- Added competition for both the external and internal managers; and
- The ability to move funds to the best performing fund manager.

1.4.22 This option would send a clear message of intent to our existing fund manager – do better than the in-house team or lose more of our portfolio.

1.4.23 With the support of our Treasury Adviser (via their model portfolio and their regular updates on the economy / rate movements etc), it would be expected that the in-house team would be able to generate returns using the fixed interest rate and call market that would be competitive and meet the expectations contained within the Medium Term Financial Strategy.

1.4.24 I am able to advise Members that in response to the disappointing first quarter returns achieved by our external Fund Manager, **I did sanction the investment of £5.5m of cash flow surplus at c4.99% for one year out to July 2007** and subsequently called back £4m from our Fund Manager. These funds are now being managed in-house. The rate of return is consistent with the running rate on our fund manager's portfolio in August and secures a return in excess of the 4.9% used in the Medium Term Financial Strategy.

1.4.25 The dilemma is always, of course, about 'striking the right balance'. External fund managers are, by definition, there to make calculated decisions about the investment market weighing up and responding to risks. The investments made by our fund managers are by and large very liquid. Investments via the fixed interest rate and call market are by definition less liquid (and therefore we might not be able to respond quickly to opportunities), but more certain.

1.4.26 Were Members to endorse the 'split fund' option I would propose, having taken advice from our Treasury Adviser, that the **maximum amount of funds** that is at any one time managed by the in-house team is capped at 50% of the funds available. In cash terms, this would equate to a maximum of £14m at the present time.

1.4.27 Whilst this maximum amount needs to be recorded for the purposes of the investment strategy, **in reality** I would not expect the in-house team to manage such a significant sum. Members will appreciate that there may be resource implications for my team if they were to assume day-to-day responsibility for the investment portfolio (see also para 1.6).

1.5 Legal Implications

1.5.1 There are no legal implications that need to be considered.

1.6 Finance and Value for Money Considerations

1.6.1 In order to set a sustainable Medium Term Financial Strategy, the Council is dependent on the returns achieved on its investments. Therefore, any performance related shortfall needs to be addressed promptly. Our existing fund manager is fully aware of the concerns we have about recent performance and has agreed to attend the next meeting of the Finance & Property Advisory Board on 4 October 2006 to explain the situation and answer any questions.

1.6.2 If we wish to replace our fund manager at any stage, the Council will need to undertake a tendering exercise which we estimate will cost £4,000. This is presently unbudgeted, but if the need arises, a virement will be sought.

1.6.3 The latest prediction of cash returns by our external fund manager is consistent with budget provision.

1.6.4 Whilst a re-balancing of the split of funds between in-house and external fund managers could see a fall in fees, there could be resource implications for the in-house team which would need to be kept under review.

1.7 Risk Assessment

1.7.1 A diversification of the risk to returns is considered appropriate in view of the relatively poor returns achieved by the Council's external fund manager.

1.8 Summary

1.8.1 The enhancement of the service provided by our Treasury Adviser has added to the treasury expertise available to the Council and, if used to the fullest extent, could provide significant benefits, most notably in the area of treasury management but also in technical and other added value areas.

1.8.2 In respect of treasury management, our Treasury Adviser has helped to identify some useful changes to our Annual Investment Strategy and these are commended to Members.

1.8.3 As to the position of our fund manager, it is clear that they are disappointed in their performance (as are we) and they have taken further steps to remedy weaknesses in systems and personnel. They have offered to reassure Members of their ability to recover from the latest set back and of their commitment to the Council in the future. I have, therefore, taken up that offer and arranged for them to make a presentation to the Finance & Property Advisory Board on 4 October 2006. I am sure the Cabinet Member for Resources and Capital Projects and the Chairman of the Advisory Board would join me in inviting **all Members** to that presentation.

1.8.4 For the future, I and our Treasury Adviser are convinced that a **gradualist approach** might provide the greatest incentive for our fund manager to improve returns and it is, therefore, suggested that this approach be adopted and kept under constant review by the Executive via the Finance & Property Advisory Board.

1.9 Recommendations

1.9.1 Cabinet is invited to **RECOMMEND** to Council that:

1) The amendments to the Treasury Management Strategy Statement and Annual Investment Strategy and Appendices outlined at paragraph 1.2.3 be approved;

2) If and when it is considered appropriate, up to 50% of funds available for more than one year be withdrawn from the external fund manager and managed internally;

3) The fund manager's performance is monitored in accordance with the parameters set out in this report, and action is taken as necessary; and

4) In the event that a new external fund manager is to be appointed, our existing Treasury Adviser be appointed as consultants to that process.

Background papers: contact: John Pickup

Nil

Sharon Shelton
Director of Finance