TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

07 September 2015

Report of the Director of Finance & Transformation

Part 1- Public

Matters for Recommendation to Cabinet – Council Decision

1 TREASURY MANAGEMENT MID-YEAR REVIEW 2015/16

This report provides an update on treasury management activity undertaken during the period April to July of the current financial year. The report also includes a mid-year review of the current financial year's Annual Investment Strategy and reminds Members of the parameters that define the Council's risk appetite. 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.

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 April to July of the 2015/16 financial year.
- Use of borrowing.
- Compliance with Treasury and Prudential Limits for 2015/16.
- A review of the risk parameters contained in the 2015/16 Annual Investment Strategy.

1.2 Economic Background

1.2.1 Thus far in 2015/16:

- The May Inflation Report saw the Bank of England reduce its forecast for annual growth in 2015 to 2.5% (from 2.9%) and in 2016 to 2.7% (also from 2.9%). Contributing factors to these downward revisions included a slowing of growth in Q1 2015 to 0.4% (2.9% y/y) and a more pessimistic view on the rate and timing of growth in labour productivity. Growth in Q2 rebounded returning 0.7% for the quarter (2.6% y/y).
- CPI inflation fell to -0.1% in April, rose to 0.1% in May and fell again to 0.0% in June. This dip in inflation is only expected to last for a short period until the fall in oil and food prices drop out of the twelve month calculation. CPI is expected to rise especially during Q4 2015 and be marginally higher than the 2.0% target two years from now.
- In June the Greek government, led by an anti-austerity party Syriza, made a strong push to renegotiate the country's debt repayments. This was met with a robust rejection by the European Central Bank and European Union. Following the imposition of capital controls and temporary closure of Greek banks a third bailout package was agreed.
- In July, Governor Carney, commented that an interest rate rise would come 'into sharper relief around the turn of the year'. The misconception that this implied a rate rise in 2015 has since been dispelled. Since then, the August Monetary Policy Committee meeting saw one of the nine member committee vote in favour of an immediate rate rise.
- The American economy experienced disappointing growth in Q1 2015. GDP grew by 0.6% on an annualised basis due to bad weather hitting construction and consumer spending, a ports strike and the near 20% appreciation in the value of the dollar. GDP recovered strongly in Q2 rising 2.3% y/y and a

resumption to full recovery from the financial crisis. To counter inflationary pressures the Federal Reserve is expected to raise interest rates before the end of 2015 and be the first western economy to do so.

- The ECB announced a €1.1 trillion programme of quantitative easing in January 2015. The programme which started in March and will run to September 2016 has already had a beneficial impact in improving confidence and sentiment in the EZ. The recent trend of marginal increases in GDP has continued with GDP of 0.4% in Q1 2015 (1.0% y/y) and 0.3% in Q2 (1.25% y/y). A period of deflation also ended when inflation returned to 0.0% in April.

- In an effort to maintain growth in the Chinese economy (7% target) the Yuan was devalued in August.

1.3 Interest Rate Forecast

1.3.1 The Bank Rate has remained at an emergency level of 0.5% for the last 6 years. Capita's latest forecast, updated May 2015, anticipates the Bank Rate will remain at this level for a further 9 months before rising in the second quarter of 2016. This is six months later than anticipated in the 2015/16 Annual Investment Strategy.

Rate	Now %	Sep-15 %	Dec-15 %	Mar-16 %	Jun-16 %	Sep-16 %	Dec-16 %	Mar-17 %	Jun-17 %	Sep-17 %
Bank Rate	**0.50**	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.50**
3 mth LIBID	**0.46**	**0.50**	**0.60**	**0.70**	**0.80**	**0.90**	**1.10**	**1.30**	**1.40**	**1.50**
6 mth LIBID	**0.63**	**0.70**	**0.80**	**0.90**	**1.00**	**1.10**	**1.30**	**1.50**	**1.60**	**1.70**
12 mthLIBID	**0.94**	**1.00**	**1.10**	**1.20**	**1.30**	**1.40**	**1.60**	**1.80**	**1.90**	**2.00**
25yr PWLB	**3.31**	**3.40**	**3.60**	**3.80**	**3.90**	**4.00**	**4.10**	**4.20**	**4.30**	**4.40**

1.4 Investment Portfolio

1.4.1 The Annual Investment Strategy for the 2015/16 financial year was approved by Council on 17 February 2015. The Strategy outlines the Council's investment priorities as follows:

- Security of Capital,

- Liquidity.

1.4.2 In addition the Council aims to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In particular, for 2015/16 the Council will 'avoid locking into longer term deals while investment rates continue their current low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile'. The Council has adopted Capita's recommended creditworthiness approach which incorporates the credit ratings from each of the three main rating agencies and includes sovereign credit ratings and a market view of risk using credit default swap (CDS) data.

1.4.3 A full list of investments held on 31 July 2015 and our lending list in operation on that date are provided at **[Annexes 1 and 2]**.

1.4.4 As illustrated above, investment rates available in the market are at a historical low. The average level of cash flow funds available for investment purposes to the end of July 2015 was £12.7m. These funds were available on a temporary basis and the amount mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The Authority holds £13.5m of core cash balances. These funds are for the most part available to invest for more than one year, albeit some funds will need to be recalled towards the end of the financial year to top-up daily cash balances.

1.4.5 At the end of July 2015 funds invested and interest earned is set out in the table below:

	Funds invested at 31 July 2015 £m	**Average duration to maturity Days**	**Weighted average rate of return %**	**Interest earned to 31 July 2015 £**	**Gross annualised return %**	**LIBID benchmark %**
Cash flow	12.25	87	0.69	26,300	0.62	0.36 (7 Day)
Core funds	13.45	177	0.83	36,200	0.80	0.46 (3 Month)
Total	25.70	134	0.76	62,500	0.71	0.41 (Average)

1.4.6 Interest earned of £62,500 is £6,500 better than budget for the same period and 30 basis points above benchmark. The additional income is wholly attributed to higher than expected cash flow and core fund balances. The pattern of income generation is expected to be maintained throughout the year such that Income for the financial year as a whole will be £15,000 to £20,000 better than budget.

1.4.7 **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 undertaken to take advantage of the higher yields available. In April £5m nine month fixed term investments were undertaken yielding circa 0.8%. More recently £4m six month fixed term investments have been placed yielding an average of 0.7%. Further, shorter duration, term deposits are likely to be placed in the autumn to take advantage of peak cash flow balances.

1.4.8 **Core funds**. Following the transfer of all core fund investments from our extremal fund manager to in-house management in August 2014, the opportunity to enhance yield by extending duration has continued. The current core fund portfolio includes a mix of nine and twelve month deposits together with one high yielding call account. The pattern of maturities (each month from December to April) is designed to ensure additional liquidity is available to the Council to support spending towards the end of the financial year and to take advantage of improved offers from banks as we approach a rise in Bank Rate.

1.5 Use of Borrowing

1.5.1 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 2015/16 Investment Strategy. 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. However, no borrowing was undertaken in the period April 2015 to July 2015.

1.6 Compliance with the Annual Investment Strategy

1.6.1 Throughout April to July 2015 all of the requirements contained in the 2015/16 Annual Investment Strategy 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 complied with.

1.6.2 In addition the Council has operated within the treasury limits and prudential indicators set out in the 2015/16 Annual Investment Strategy and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found at **[Annex 3]** to this report.

1.7 Review of Risk Parameters

1.7.1 Members will recall the detailed consideration that was given to the 2015/16 Annual Investment Strategy at the January 2015 meeting of the Audit Committee. The strategy includes the parameters that aim to limit the Council's exposure to investment risks by requiring investments to be placed with highly credit rated institutions and that those investments are diversified across a range of counterparties. More specifically the 2015/16 Annual Investment Strategy requires:

- 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 restricted to no more than 20% of funds per Sovereign.

- Exposure to individual counterparties / groups of related counterparty must not exceed 20% of funds (25% of funds for part state owned UK Banks).

- In selecting suitable counterparties the Council has adopted Capita's credit worthiness methodology. The methodology combines the output from all three credit rating agencies including credit watches / outlooks and credit default swap data to assign a durational band to a financial institution (100 days, 6 months, 12 months, 5 years, etc.). At the time of placing an investment the financial institution must be assigned a durational band of at least 100 days. This broadly equates to a minimum long term credit rating of Fitch A- (high) and a short term credit rating of Fitch F1 (strong).

- The duration of an investment in a foreign bank must not exceed Capita's recommendation. For UK financial institutions Capita's duration recommendation can be enhanced by up to three months subject to the combined duration (Capita recommendation plus the enhancement) not exceeding 12 months.

- Money Market funds should be rated Fitch AAAmmf or equivalent and exposure limited to no more that 20% per fund.

- Enhanced Money Funds should be rated AAA and exposure limited to no more than 10% per fund and 20% to all such funds.

1.7.2 The 2015/16 Strategy also limits 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.

1.7.3 In preparing this report the risk parameters have been reviewed and are considered appropriate to protect the Council's interests. The Council has access, both directly and via brokers, to a sufficient number of high credit rated financial institutions enabling it to maintain a diverse portfolio; with an appropriate level of liquidity; that makes a positive contribution to income generation. No changes to the risk parameters are proposed at the present time.

1.8 Legal Implications

1.8.1 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority including securing effective arrangements for treasury management. In addition, Capita are employed to provide independent advice on legislative and professional changes that impact on the treasury management function.

1.8.2 This mid-year review report fulfils a requirement in The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

1.9 Financial and Value for Money Considerations

1.9.1 The Bank Rate has remained at a historic low of 0.5% for over 6 years. Capita, our treasury advisors, in common with other market forecasts, anticipate a rise in Bank Rate sometime during the second quarter of 2016.

1.9.2 The Funding for Lending initiative introduced by the Bank of England in summer 2012 had a significant downward impact on returns being offered by financial institutions at the time and that impact has continued.

1.9.3 At the end of July Investment income is £6,500 better than expected. This pattern is expected to be repeated throughout 2015/16 resulting in income for the year as a whole being £15,000 to £20,000 above budget.

1.9.4 Investment performance is monitored against relevant benchmarks and compared to other local authorities in Kent and the broader local authority pool via Capita's benchmarking service.

1.10 Risk Assessment

1.10.1 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.

1.11 Equality Impact Assessment

1.11.1 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

1.12 Recommendations

1.12.1 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 July 2015.

2) Retain the existing parameters intended to limit the Council's exposure to investment risks.

Background papers: contact: Mike Withey

Capita Interest Rate Forecast (August 2015)

Sharon Shelton
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