TONBRIDGE & MALLING BOROUGH COUNCIL

CABINET

04 February 2014

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2014/15

The report provides details of investments undertaken and returns achieved in the first nine months of the current financial year. Members are invited to consider amending the current split of investment responsibilities for in-house and externally managed funds. The report concludes with a recommendation to adopt the Treasury Management Strategy Statement and Annual Investment Strategy for 2014/15.

1.1 Introduction

1.1.1 The Local Government Act 2003 requires the Council to 'have regard to the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable'.

1.1.2 The Act also requires the Council to set out its Treasury Management Strategy Statement for borrowing and to prepare an Annual Investment Strategy; setting out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.1.3 The Strategies are set out in a single document at **[Annex 3]** to this report.

1.1.4 The portfolio of the Audit Committee includes the review of treasury management activities. Accordingly, that Committee was asked to review the matters covered by this report and **[Annex 3]** on 27 January 2014. Due to timing issues it will be necessary to verbally report upon any recommendations and observations made by the Audit Committee.

1.1.5 The Strategy is a complex technical document and is a specialist area of work, I should be grateful if Members could **raise any queries with the author of this report (Michael Withey ext. 6103) in advance of the meeting as Michael will not be present on 4 February**.

1.2 Return on Investments

1.2.1 In accordance with the CIPFA Treasury Management Code of Practice, 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. We find ourselves in a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate and have been suppressed further in recent months by the Bank of England's 'Funding for Lending' scheme introduced to support economic recovery. As a consequence, investment returns are expected to remain low relative to pre 2008 financial crisis levels throughout the remainder of this financial year and the next (2014/15).

1.2.2 Cash flow funds are available on a temporary basis and their amount varies from month to month and during the course of each month dependent on the timing of receipts (collection of business rates, council tax, grants and other sources of income) and payments (to government, precepting authorities, housing benefit recipients, staff and suppliers). The authority holds £15.4m of core cash balances for investment purposes which are managed by our external fund manager. These funds which comprise our revenue and capital reserves are for the most part available to invest for more than one year.

1.2.3 At the end of December 2013 funds invested and interest earned is set out in the table below:

	Funds invested at 31 Dec 2013 £m	Average duration to maturity Yrs	Weighted average rate of return %	Interest earned to 31 Dec 2013 £	Gross annualised return to 31 Dec 2013 %	7 day Libid benchmark %
In-house cash flow excluding Landsbanki	8.0	0.12	0.77	55,600	0.68	0.41
Externally managed core funds	15.4	0.81	0.60	65,000	0.56	0.41
Total	23.4	0.57	0.66	120,600	0.61	0.41

1.2.4 Whilst the authority bettered the 7 day LIBID benchmark by 20 basis points interest earned of £120,600 is £58,600 lower than our 2013/14 original estimate for the same period. This underperformance against budget is mainly attributed to the lower than expected return delivered by our external fund manager and is explored in more detail below.

1.2.5 **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

1.2.6 In addition to term deposits the opportunity to generate additional yield is also achieved by utilising notice accounts. At 31 December 2013, £1.0m was deposited in a National Westminster 95 day notice account at a rate of 0.60% per annum and £1.0m deposited in a 35 day notice account with Barclays at 0.54% per annum.

1.2.7 The Council achieved a return of 0.68% on its in-house managed cash flow investments for the period ended December 2013, compared to a 7-day LIBID benchmark of 0.41%. However, in cash terms investment income achieved fell short of budget by £7,600. Our revised estimates assume income for the year of £72,000 implying a shortfall against the original 2013/14 estimate of £9,800 for the year as a whole.

1.2.8 **Externally managed core funds**. In accordance with our 2013/14 Investment Strategy 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 December 2013, compared to a 7-day LIBID benchmark of 0.41%. Excluding unrealised losses on recent UK Gilt purchases of £71,000 investment income achieved for the period ended December 2013 is £65,000.

1.2.9 At the end of December 2013 the value of the fund stood at £15.4m. This was invested at an average rate of 0.60% and an average maturity of 0.81 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 performance to date coupled with no real prospect of an improvement in yields for the remainder of this financial year a return of 0.60% is considered more realistic. Our revised estimates for this financial year have been prepared using this lower return and anticipate income for the year as a whole will be £92,400. This represents a shortfall against the original estimate of £61,850.

1.2.10 **Current investment position**. A full list of investments held on 31 December 2013 is provided at **[Annex 1]** of this report and a copy of our internal lending list of the same date is provided at **[Annex 2]**. The yields on the total sum invested of £23.4m exclusive of Landsbanki is 0.66% comprising internally managed investments of £8.0m at 0.77% and externally managed investments of £15.4m at 0.60%.

1.3 Treasury Management Strategy Statement and Annual Investment Strategy for 2014/15

1.3.1 **Risk appetite**. Three years ago Members supported a rationalisation of our counterparty and non-UK sovereign exposure limits around a single figure of 25% and applied the result to both the in-house and externally managed portfolios. At that time Members also reviewed and made a modest amendment to the minimum credit criteria taking it to Fitch long term AA- (very high), short term F1+ (exceptionally strong). Two years ago, in response to an avalanche of downgrades to bank credit ratings, Members supported a lowering of our minimum counterparty credit criteria to Fitch A (high), F1 (strong) and provided some offset by reducing our counterparty and non-UK sovereign exposure limits to 20%. Audit Committee in October 2012 recommended that the exposure limits for investment in the UK nationalised / part nationalised banks revert back to a maximum of 25% per bank / group and also lowered our minimum AAA (highest) sovereign requirement for the UK to Fitch AA- (very high) or equivalent. That AA- requirement was extended to all sovereigns in the current investment strategy.

1.3.2 Officers are content that the current criteria to invest in highly rated financial institutions regulated by similarly rated sovereigns is considered appropriate to safeguard the authority's interests and provides an appropriate balance between the security and diversity of our investments and the desire to generate an income stream. As a consequence, **no changes to the minimum sovereign / counterparty credit rating or exposure limits are proposed in the Annual Investment Strategy for the 2014/15 financial year**.

1.3.3 **Management of cash flow and core funds**. 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 and its subsequent expenditure to meet payment obligations.

1.3.4 The 2013/14 Investment Strategy 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 without undue added risk. In each of the last three years, in-house investment has been the preferred option for investing such surpluses. **The 2014/15 Annual Investment Strategy presumes all cash flow funds will be managed in-house with no requirement to transfer funds to the external fund manager**.

1.3.5 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 fund balance, currently £15.4m, is expected to average £11.4m during 2014/15 and the Council's Treasury Management Team are of the view that the core fund is now of a size that its investment can be managed in-house.

1.3.6 External fund management has enabled the Council to maintain a well diversified portfolio with investments in numerous high quality financial institutions. The fund manager's longer term exposure to banks has generally been via certificates of deposit (CDs) which are preferred by some institutions. CDs can be traded on secondary markets and thus provide a source of liquidity should the need arise. In-house longer term investment in banks has in the past been via broker or directly arranged fixed term deposits. Such deposits, as their name implies, are fixed for the duration. Early redemption of fixed term deposits may be possible in some cases but not without penalty. The Council has now secured a custody facility via King & Shaxon to enable CDs and other market tradable instruments (e.g. Gilts and Treasury Bills) to be acquired (and sold) direct. The addition of this facility will, subject to counterparty investment limits, ensure the Council continues to have access to a broad range of high quality institutions.

1.3.7 UK Gilts are seen as a safe haven in times of market stress. In the past our external fund manager has been able to take advantage of 'blips' in Gilt prices that the market stress (caused by an event) generates to make additional income by trading Gilts. In the first nine month of this financial year, whilst there have been opportunities to generate capital profits on Gilt trades (e.g. US budget / debt ceiling negotiations), they have not been taken. Going forward Gilt yields are expected to rise in anticipation of interest rate increases. Our external treasury advisor, Capita, are of the view that whilst there may be geo-political factors that result in Gilts being treated as a safe haven investment option by investors such opportunities are less likely in the medium term. Moreover, the current gilt holding (£2m maturing in 2018) that was acquired in May and June of this year is currently recording an unrealised loss of some £71,000. To avoid that loss materialising the investment will need to be maintained to maturity. The yield at purchase of 1.16% whilst attractive given current interest rates is likely to underwhelm in three and four years time.

1.3.8 In-house management of cash flow surpluses involves on average five investments per day (a mix of new investments, recalling existing investments and or repeating the previous day's investments). Management of the core fund is expected to involve only two / three investments each month which can be readily absorbed within the existing in-house staff resource. In addition, although the overriding motivation for in-house management of the core fund is its diminishing size, the transfer will generate a saving in external fund management fees. The fees payable on a portfolio of £11.4m will be circa £17,000 and provide a useful contribution to the Council's revenue savings targets.

1.3.9 Whilst a specific date for the transfer of responsibility has yet to be determined the expectation is that **by the end of the 2014 /15 financial year all core fund investments will be managed in-house**.

1.3.10 **External treasury advisor's recommended duration**. Our advisor's assessment of counterparty creditworthiness assigns financial institutions to a duration band. The bands for those institutions considered appropriate for local authority investment range from 100 days to five years. Institutions which are considered inappropriate for investment are assigned a nil duration. The assessment incorporates a market view of risk using credit default swap data. A credit default swap (CDS) can be likened to insurance taken out by investors to guard against the risk of default. The aggregate value of CDS trades reached a peak at the height of the Eurozone sovereign debt crisis in December 2011 prompting the Bank of England Financial Policy Committee to warn UK banks to prepare to withstand an 'extraordinarily serious and threatening' economic environment. Since then, the European Central Bank has introduced measures to ease bank liquidity, established a mechanism to contain sovereign bond yields and made progress on a European Banking Union. The aggregate value of CDS trades has been on a downward trajectory since December 2011 and is now broadly in line with levels pre the 2008 financial crisis.

1.3.11 The CDS data for individual banks has generally followed the same downward trajectory described above. However, in recent weeks and on a limited number of occasions, the fall in CDS data for Barclays Bank has failed to keep pace with the fall in the aggregate value of CDS trades. This has resulted in Barclays CDS data being elevated above the norm triggering a change in Capita's duration recommendation from 100 days, based on credit ratings alone, to nil days when CDS data is also taken into consideration. The 'nil duration' applied at the time of writing this report and explains why Barclays, which has featured on our lending list in previous reports to Audit Committee, is absent from our lending list of 31st December **[Annex 2]**. In recent months 'blips' in CDS data have affected other counterparties on our lending list in a similar fashion including the Nationwide Building Society and Santander UK.

1.3.12 Our current Investment strategy requires that at the time an investment is placed we use Capita's duration recommendation to 'determine' the duration of an investment. **The strategy for 2014/15 introduces a degree of flexibility and requires that Capita's recommended duration is used to 'inform' the duration of an investment**. This flexibility will be incorporated into our detailed Treasury Management Practices that support the Annual Investment Strategy. The flexibility will be limited to Capita's recommended duration plus three months and will only be applied to UK financial institutions.

1.3.13 **Updated strategies**. Whilst no changes are being made to the Council's risk appetite, the proposed changes in management arrangements and investment duration flexibility have been incorporated into the Treasury Management Strategy and Annual Investment Strategy for 2014/15. Both strategies are combined into a single document and are provided at **[Annex 3]**. Except where outlined above no other material changes to the strategies have been made. A recommendation to adopt **[Annex 3]** appears at paragraph 1.9.1(6).

1.4 Money Market Fund Regulatory Changes

1.4.1 Both the Securities Commission in America and more importantly from our perspective, the European Commission are in the process of consulting on changes to the regulatory framework governing money market funds. Money market funds (MMFs) form a critical component in our daily cash flow management. They provide the same day access to cash as a traditional bank deposit account; allow surplus cash to be placed in a AAA credit rated product and; ensure our peak monthly cash balances are disbursed across a range of counterparties.

1.4.2 The current yield on a typical fund used by the Council is 0.4% and falls roughly mid-way between the yield from our bank deposit accounts at 0.6% and that offered by the UK Debt Management Office at 0.25%. Most commentators believe that if all of the proposed regulatory changes came into being, MMFs would no longer be viable. Any regulatory change will involve a ‘bedding-in period’ to allow MMFs to adapt to the new requirements. So whilst change is inevitable it is unlikely to impact on our cash management operation during 2014/15. Members will be updated as regulations develop and our existing MMFs response to those regulatory changes emerges.

1.5 Legal Implications

1.5.1 These are set out above and at **[Annex 3]** to this report. In addition, Capita are employed to provide independent advice on legislative and professional changes that impact on the treasury management function.

1.6 Financial and Value for Money Considerations

1.6.1 The Bank Rate is expected to remain at a historical low (0.5%) throughout the remainder of this financial year and the next (2014/15). The ‘Funding for Lending’ initiative introduced by the Bank of England in summer 2012 has had a significant downward impact on returns being offered by financial institutions. As a consequence budgeted returns for both cash flow and core funds have been revised downward for 2013/14. Similar low returns are anticipated in 2014/15 at 0.75% for cash flow and 0.85% for core funds.

1.6.2 The performance of our fund manager is monitored against all of the players in the public sector cash management market place using data provided by Capita. In addition, the performances of both externally and internally managed investments are monitored against relevant benchmarks. In-house returns are also monitored against other Kent authorities and the broader local authority pool via Capita’s benchmarking service.

1.6.3 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. Members are referred to the Part 2 report submitted to Audit Committee 7 October 2013 detailing current recovery action.

1.7 Risk Assessment

1.7.1 Capita are employed to advise on the content of the Treasury Management Strategy Statement and Annual Investment Strategy and this, coupled with a regular audit of treasury activities ensures that the requirements of the Strategy and the Treasury Policy Statement adopted by this Council are complied with.

1.7.2 Credit ratings remain a key tool in assessing risk. It is recognised that their use should be supplemented with sovereign ratings and market intelligence. Appropriate sovereign, group and counterparty limits need to be established to ensure an appropriate level of diversification.

1.7.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2014/15 Strategy have been minimised.

1.8 Equality Impact Assessment

1.8.1 See 'Screening for equality impacts' table at end of report.

1.9 Recommendations

1.9.1 Cabinet are invited to consider and **RECOMMEND** that full Council:

1) note the treasury management position as at 31 December 2013;

2) retain the current minimum counterparty credit ratings and the current maximum sovereign / counterparty exposure limits.

3) agrees all cash flow funds in 2014/15 be managed in-house with no requirement to transfer funds to the external fund manager;

4) agrees to the transfer of responsibility for the Council's core fund investments from the external fund manager to in-house management during 2014/15;

5) allows some flexibility over the duration of investments placed with UK financial institutions as outlined in paragraph 1.3.12;

6) adopts the Treasury Management Strategy Statement and Annual Investment Strategy for 2014/15 set out at **[Annex 3]**.

Background papers: contact: Michael Withey

Templates and forecasts provided by Capita
Fitch Rating Definitions.

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 different groups in the community?	No	N/A
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.