TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

20 June 2016

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Cabinet – Council Decision

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2015/16

The report provides an update on treasury management activity undertaken during April and May of the current financial year. The treasury management outturn position for 2015/16 is due to be reported to the June meeting of Cabinet and is also included in this report. Following a commentary on the application of credit default swap data (market view of risk) Member approval is sought to enhance the existing flexibility afforded to officers when determining the appropriate duration for term deposits.

1.1 Introduction

1.1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a revised Code of Practice for Treasury Management in November 2009. The revised Code was adopted by the Council on 18 February 2010 and suggests that Members should be informed of treasury management activity at least twice a year, but preferably quarterly. This report, therefore, ensures this Council is embracing best practice in accordance with CIPFA's revised Code of Practice and subsequent updates.

1.2 Economic Background

1.2.1 Thus far in 2016/17:

- The start of 2016 saw significant falls in stock markets around the world following renewed concerns of a downturn in the Chinese economy and the implications for global growth and commodity prices. Whilst stock markets have largely recovered in recent weeks the prospect of weaker global growth going forward remains an issue.

- As part of his March budget, the Chancellor presented the latest forecasts from the Office for Budgetary Responsibility (OBR) for both economic growth and public sector borrowing. The OBR has suggested that productivity growth is set to remain weak and that this will have a meaningful effect on economic growth going forward. Consequently, GDP growth forecasts were revised down and are now predicting GDP to be between 2.0% and 2.2% over the course of the next 5 years (vs 2.2% and 2.5% Autumn Statement 2015). Faced with an economy growing slower than anticipated, the Chancellor introduced additional cuts in government spending to allow a budget surplus to be returned in 2019/20.

- At the May meeting of the Bank of England's Monetary Policy Committee (MPC), members voted unanimously to hold the Bank Rate at 0.5% and make no change to the programme of quantitative easing. Faced with low inflation, a slowing economy, worrisome foreign markets and the uncertainty of the referendum on the UK's membership of the European Union, there is little to no pressure on the MPC to tighten monetary policy in the near term.

- The Consumer Price Index (CPI) rose by 0.3% in the twelve months to April and was around 0% throughout 2015. The BoE anticipate inflation will rise above the 2% target over the course of the next two to three years. Given the anticipated trajectory of inflation, the current market expectation of a rate rise in the UK being delayed to 2018, looks pessimistic. Whilst recent commentary from the MPC suggests they are likely to refrain from a rate rise in 2016, a rise sometime in 2017 would fit with inflation forecasts.

- In America the Federal Reserve raised the Fed Rate (equivalent of our Bank Rate) by 0.25% to 0.50% in December 2015. The rise was the first since 2006. Current market expectation is for the Fed Rate to rise again in July.

- The March meeting of the European Central Bank saw an expansion of its programme of quantitative easing and a further cut below zero of the deposit rate. Eurozone activity and business confidence surveys showed improvement in both April and May and deflationary pressures also appeared to be easing. A further tranche of financial support for Greece was also announced in May.

1.3 Interest Rate Forecast

1.3.1 The Bank Rate has remained at an emergency level of 0.5% for the last 7 years. The 2015/16 Annual Investment Strategy was prepared in December 2015 at a time when UK economic growth and inflation expectations were such that a rise in Bank Rate in the second quarter of 2016 was considered likely. Capita's latest forecast, dated May 2016, anticipates the rise in Bank Rate will be delayed a further 9 months to the first quarter of 2017.

1.3.2 The forecast will be updated in early July once the result of the EU referendum is known.

Capita Interest Rate Forecast – May 2016												
Rate	Now %	Jun-16 %	Sep-16 %	Dec-16 %	Mar-17 %	Jun-17 %	Sep-17 %	Dec-17 %	Mar-18 %	Jun-18 %	Sep-18 %	Dec-18 %
Bank Rate	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50
3 mth LIBID	0.46	0.50	0.50	0.60	0.80	0.90	1.00	1.10	1.30	1.30	1.60	1.80
6 mth LIBID	0.62	0.70	0.70	0.80	0.90	1.00	1.20	1.40	1.60	1.70	1.80	2.00
12 mthLIBID	0.89	1.00	1.00	1.10	1.20	1.30	1.50	1.70	1.90	2.00	2.10	2.30
25yr PWLB	3.14	3.20	3.30	3.30	3.50	3.50	3.60	3.60	3.70	3.70	3.70	3.80

1.4 2016/17 Treasury Management Performance

1.4.1 The Annual Investment Strategy for the 2016/17 financial year was approved by Council on 16 February 2016. 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 2016/17 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".

1.4.3 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.

1.4.4 A full list of investments held on 27 May 2016 and our internal lending list in operation on that date are shown in **[Annexes 1 and 2]** of this report.

1.4.5 As illustrated above, investment rates available in the market are at an historical low point. The average level of cash flow funds available for investment purposes to the end of May 2016 was £12.6m. 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 £15.6m of core cash balances. 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.

1.4.6 As at the end of May 2016 funds invested and interest earned is set out in the table below:

	Funds invested at 31 May 2016 £m	Average duration to maturity Days	Weighted average rate of return %	Interest earned to 31 May 2016 £	Gross annualised return to 31 May 2016	LIBID benchmark %
Cash flow	9.7	103	0.74	14,100	0.67	0.36 (7 Day)
Core funds	15.6	133	0.81	20,900	0.80	0.46 (3 Mth)
Total	25.3	121	0.78	35,000	0.75	0.41 (Ave)

1.4.7 Interest earned of £35,000 to the end of May is £5,400 better than the original estimate for the same period. Despite the likelihood of a Bank Rate rise being delayed, cash flow and core fund balances are higher than anticipated such that investment income for the year as a whole is expected to meet (and may better) the 2016/17 budget provision of £206,000.

1.4.8 **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. Thus far £5m nine month fixed term investments have been placed yielding circa 0.8%.

1.4.9 The current cash flow forecast **[Annex 3]** points to more fixed term investment opportunities being available as the year progresses albeit duration will need to be scaled back to ensure these funds are available to support spending needs towards the end of the financial year.

1.4.10 A significant element of the Council’s daily cash balance relates to the collection of business rates, the majority of which is paid over to Government, KCC and Kent Fire and Rescue. Whilst the Council is responsible for determining when to collect, Government determines when payments to themselves and others are due. In 2014/15 and earlier years payments to Government and others were spread over ten monthly instalments starting in April and ending the following January. For 2015/16, outgoing payments were spread over 12 equal monthly instalments starting in April. The result was higher daily balances, which were available for longer, enabling the Council to undertake more fixed term investments than would otherwise have been the case. The 2015/16 payment profile to Government is being retained by them for 2016/17 which will offset the adverse impact on income from the delay in UK interest rate rises referred to above.

1.4.11 **Core Funds**. Following the transfer of all core fund investments from our external fund manager to in-house management in July 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 two high yielding call accounts (one bank deposit account and one money market fund). The pattern of maturities is designed to ensure additional liquidity is available to the Council to support spending should the need arise and to take advantage of interest rate rises when they occur.

1.4.12 Core fund balances are also higher than anticipated reflecting provisions under the Business Rates Retention Scheme to meet the cost of appeals which have yet to be determined by the Valuation Office. Again these higher balances are expected to offset the impact of a delay in interest rate rises.

1.5 Benchmarking

1.5.1 The Council takes advantage of Capita's benchmarking facility which enables performance to be gauged against Capita's other local authority clients. An extract from the latest benchmarking data is provided in the form of a scatter graph at **[Annex 4]**. The graph shows the return (vertical scale) vs. the credit / duration risk (horizontal scale) associated with an authority's investments. As at 31 March 2016 our return at 0.75% (purple diamond) was marginally above the average of 0.74% for all other local authorities and relative to the Council's exposure to credit / duration risk that return exceeded Capita's predicted return (just above the upper boundary indicated by the green diagonal line). The Council's risk exposure was also below the local authority average.

1.6 Compliance with the 2016/17 Annual Investment Strategy (AIS)

1.6.1 Throughout April and May 2016 all of the requirements contained in the 2016/17 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. No borrowing was undertaken during April or May 2016.

1.6.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The Prudential and Treasury Indicators will be included for review as part of the treasury management report to the September 2016 meeting of Audit Committee.

1.7 2015/16 Treasury Management Outturn

1.7.1 A detailed report covering treasury management activity for the last financial year is being submitted to Cabinet on 29 June 2016 as an annex to the Revenue and Capital Outturn report for 2015/16. That annex is replicated in full and provided at **[Annex 5]** to this report.

1.7.2 A summary of the investment performance included in **[Annex 5]** is as follows:

2015/16 Financial Year	Average investment £m	Gross rate of return %	Interest earned £	Revised estimate £
Cash flow	17.0	0.65	109,850	85,000
Core funds	14.1	0.82	116,250	105,000
Total	31.1	0.73	226,100	190,000

1.7.3 The combined performance of the Authority's cash flow and core funds bettered the revised estimate by £36,100 (£58,600 better when compared to the 2015/16 original estimate).

1.8 Term Deposit Duration

1.8.1 A key part of Capita's advice to the Council is a weekly update on the creditworthiness of a financial institution. Capita's assessment uses the credit ratings provided by each of the three main rating agencies to score an institution. The score determines which durational band a bank / building society is assigned to. Banks deemed suitable for local authority investment will be assigned a durational band of 100 days, 6, 9, 12 or 24 months. The assessment also 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. Depending on a bank's CDS price relative to the average CDS for all banks, Capita will confirm the duration band based on credit ratings alone; reduce duration by one band (e.g. 6 months based on credit ratings is reduced to 3 months after taking CDS into account); or advise that no new investment is placed with the institution (the durational band becomes nil months).

1.8.2 CDS prices rose significantly following the collapse of Lehman Brothers in 2008 and 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 progressed 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 financial crisis.

1.8.3 In November 2015, Capita recognised the more benign state of the CDS market and modified their use of the data. Whilst the rational for change appeared well founded, in practice the new approach has proven to be less precise in signalling market concern for a particular institution and has the potential to trigger false warnings when average CDS prices rise dramatically.

1.8.4 Following the announcement of a referendum on the UK's membership of the European Union, a premium was applied to all UK bank CDS prices. During late March and most of April that premium resulted in Capita's duration assessment for UK banks being scaled back (typically, a six month assessment based on credit ratings was reduced to three months after applying CDS data). The time frame coincided with and delayed the reinvestment of a significant proportion of the Council's core funds and the investment of cash flow surpluses as they began to build in April. Volatility in the CDS market has since subsided and whilst those investments have now all been placed the delay was both unsatisfactory and unnecessary. However, should a similar situation arise in the future its impact can be negated.

1.8.5 When undertaking term deposits the Annual Investment Strategy affords officers the discretion to add up to three months to Capita's post CDS duration assessment. Where officers consider it appropriate, the recommendation at paragraph 1.13.1, allows that same discretion to be applied to Capita's duration assessment based on credit ratings alone. Members are reminded that term deposits are only made with the agreement of the Chief Financial Services Officer **and** Director of Finance and Transformation and that agreement is sought via a written proposal from the Treasury Manager. Each investment proposal, taking into account the likely timing of interest rate changes, addresses the security and liquidity implications of a particular investment. In future, any use of the discretion to set aside CDS data and the justification for doing so will be drawn out in the investment proposal. Members are also reminded that the discretion to extend duration by up to three months only applies to UK entities and that the combined duration (Capita duration plus three month discretion) must not exceed twelve months.

1.9 Legal Implications

1.9.1 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.

1.10 Financial and Value for Money Considerations

1.10.1 The Bank Rate has remained at a historical low (0.5%) for a seventh successive year. 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. At the end of May 2016, investment income of £35,000 has been earned exceeding the 2016/17 estimate for the same period by £5,400.

1.10.2 For the 2015/16 year as a whole the Council generated investment income of £226,100 which was £36,100 better than the 2015/16 revised estimate.

1.10.3 Performance is monitored against relevant benchmarks and against other local authorities using benchmarking data provided by Capita.

1.11 Risk Assessment

1.11.1 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.

1.12 Equality Impact Assessment

1.12.1 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act.

1.13 Recommendations

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

1) Endorse the action taken by officers in respect of treasury management activity for April and May 2016,

2) Note the 2015/16 outturn position, and

3) Enhance the flexibility afforded to officers when determining the appropriate duration for term deposits as outlined in paragraph 1.8.5

Background papers: contact: Mike Withey

Capita interest rate forecast (May 2016)
Capita benchmarking data (March 2016)

Sharon Shelton
Director of Finance and Transformation