TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

05 September 2016

Report of the Director of Finance & Transformation

Part 1- Public

Matters for Recommendation to Cabinet – Council Decision

1 TREASURY MANAGEMENT UPDATE AND MID-YEAR REVIEW 2016/17

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, retain the current risk parameters and note the review of the Council's long term cash balances.

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 2016/17 financial year.
- Use of borrowing.
- Compliance with Treasury and Prudential Limits for 2016/17.
- A review of the risk parameters contained in the 2016/17 Annual Investment Strategy.

1.2 Economic Background

1.2.1 The referendum on the UK's membership of the European Union delivered an unexpected result giving rise to both political and economic uncertainty. That uncertainty resulted in significant volatility in stock and currency markets in the immediate aftermath of the vote. Whilst the political uncertainty has been resolved, economic uncertainty will remain until the UK's trading relationships with the EU and the rest of the world are addressed. This process is expected to take a number of years.

1.2.2 Less than a week after the vote, each of the main rating agencies reviewed their credit assessment of the UK. All three agencies applied a negative outlook whilst Fitch and Standard & Poor's went further with an actual downgrade to AA. The rational for change included concern over: a slowdown in short term growth as businesses defer investment decisions; an already high budget deficit and the potential for weaker growth in the medium term if trade negotiations become protracted.

1.2.3 Both Moody's and Standard & Poor's also reviewed UK bank and building society credit ratings. Whist short and long term ratings were affirmed, outlooks have been amended from positive to stable or stable to negative. The rational point to the likelihood of lower profitability and adverse impacts on asset quality.

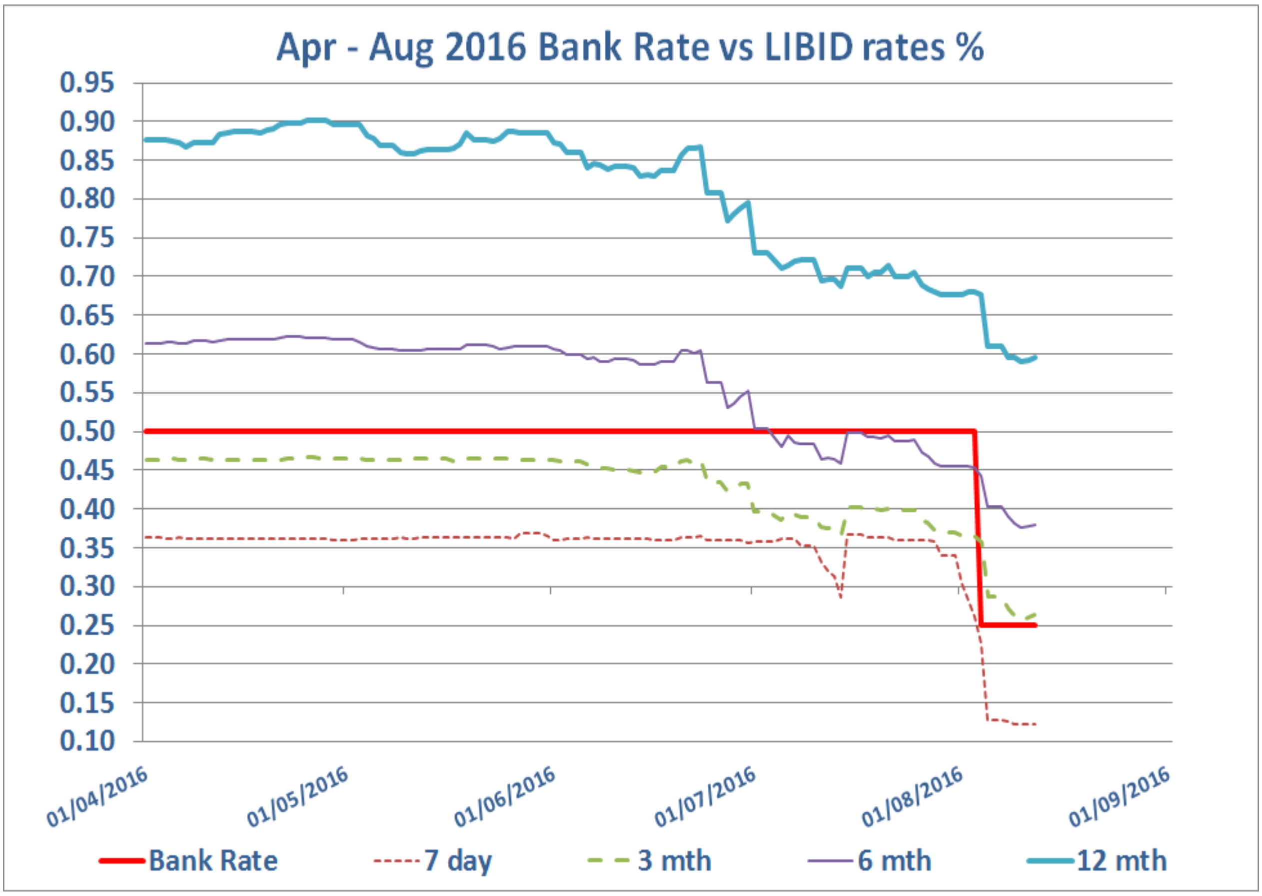
1.2.4 The UK economy grew by 2.2% in 2013, 2.9% in 2014 and 1.8% in 2015. The latest Bank of England forecasts (August 2016) anticipate GDP of 2.0% in 2016 but falling significantly relative to pre referendum estimates to 0.8% in 2017 and 1.8% in 2018.

1.2.5 Inflation (CPI) in 2015 was around 0% throughout 2015, rose to 0.3% in the year to April and was expected to rise to target (2%) over the course of the next two to three years. Following the post referendum fall in the value of sterling, CPI is now forecast to rise much more rapidly, reaching target mid-2017 and remaining around 2.3% in 2018 and 2019.

1.2.6 The Monetary Policy Committee (MPC) at its meeting in August, continued to set aside its remit to manage inflation and introduced a series of substantive measures aimed to support economic growth. The Bank Rate was cut from 0.5% to 0.25% and the Bank's Quantitative Easing (QE) programme was raised from £375bn by £60bn to fund new guilt purchases. Two new programmes were also introduced. £10bn to fund the purchase of corporate bonds and up to £100bn to provide low cost funding to banks (Term Funding Scheme).

1.2.7 The Chancellor of the Exchequer has also pledged to do 'whatever is needed' to promote growth. A package of fiscal and or expenditure plans, in support of the BoE's monetary action, is expected in the Autumn Budget Statement. Eliminating the UK's budget deficit is likely to slip further into the future.

1.2.8 The impact of the referendum and the subsequent Bank Rate cut on investment returns is demonstrated in the following table.



1.2.9 Elsewhere in the world the Federal Reserve in America 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 the autumn.

1.2.10 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, having remained at an emergency level of 0.5% for the last 7 years, was reduced to 0.25% in August. Capita's July forecast, produced just after the June referendum anticipated the cut in Bank Rate.

July 2016	Now %	Sep-16 %	Dec-16 %	Mar-17 %	Jun-17 %	Sep-17 %	Dec-17 %	Mar-18 %	Jun-18 %	Sep-18 %
Bank Rate	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50
3 mth LIBID	0.43	0.30	0.30	0.30	0.30	0.30	0.40	0.50	0.50	0.60
6 mth LIBID	0.55	0.50	0.50	0.50	0.50	0.60	0.60	0.70	0.70	0.70
12 mthLIBID	0.80	0.60	0.60	0.60	0.50	0.70	0.80	0.90	0.90	0.90
25yr PWLB	2.48	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60

1.3.2 Following the BoE meeting in August and the expectation that the Bank would take further action in the autumn if data was in-line with forecast, Capita issued the following revision.

August 2016	Now %	Sep-16 %	Dec-16 %	Mar-17 %	Jun-17 %	Sep-17 %	Dec-17 %	Mar-18 %	Jun-18 %	Sep-18 %
Bank Rate	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25
3 mth LIBID	0.39	0.30	0.20	0.20	0.20	0.20	0.20	0.30	0.30	0.30
6 mth LIBID	0.48	0.40	0.30	0.30	0.30	0.40	0.40	0.50	0.50	0.50
12 mthLIBID	0.70	0.60	0.50	0.50	0.60	0.60	0.70	0.70	0.70	0.80
25yr PWLB	2.31	2.30	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50

1.4 Investment Portfolio

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 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’. 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 2016 and our lending list in operation on that date are provided in **[Annexes 1 and 2]**.

1.4.4 The average level of cash flow funds available for investment to the end of July 2016 was £14.1m. These funds were available on a temporary basis and the amount mainly dependent on the timing of council tax and business rate collection, precept and business rate payments, receipt of grants and progress on the capital programme. Cash flow funds are received and spent during the course of a financial year. The Authority also holds £15.6m of core cash balances. These funds are for the most part available to invest for more than one year, albeit some may need to be recalled towards the end of the financial year to top-up daily cash balances. Core funds comprise the Council’s capital and revenue reserves and are being consumed over time to meet capital expenditure and ‘buy time’ to enable the authority to deliver its revenue savings targets.

1.4.5 At the end of July 2016 funds invested and interest earned is set out in the table below.

	Funds invested at 31 July 2016 £m	**Average duration to maturity Days**	**Weighted average rate of return %**	**Interest earned to 31 July 2016 £**	**Gross annualised return %**	**LIBID benchmark %**
Cash flow	14.9	84	0.74	32,750	0.69	0.35 (7 Day)
Core funds	15.6	90	0.81	42,000	0.81	0.39 (3 Month)
Total	30.5	87	0.78	74,750	0.75	0.37 (Average)

1.4.6 Interest earned of £74,750 is £13,700 more than budget for the same period and 38 basis points above benchmark. The additional income is attributed to higher than expected cash flow and core fund balances and the opportunity that this created to invest more in higher yielding term deposits. But for the outcome of the referendum and the Bank Rate cut it triggered, the pattern of income generation was expected to be maintained such that income for the year as a whole was likely to be some £30,000 above budget.

1.4.7 The cut in Bank Rate from 0.50% to 0.25% in August means this will no longer be possible. However, because the opportunity was taken before the referendum to invest as much as possible for as long as possible in term deposits, a significant proportion of this year's income is essentially locked in. The main impact of the Bank Rate cut will be felt later in the year when the core fund investments begin to mature and are reinvested at lower rates of return. **If the BoE retain the current 0.25% Bank Rate, income for the year as a whole is expected to be in-line with budget at £206,000**.

1.4.8 However, the August Bank Rate cut was accompanied by an expectation that a further cut may be needed in the autumn. Capita's August forecast (paragraph 1.3.2 above) anticipates such a scenario and incorporates a further reduction in Bank Rate to 0.1%. A number of term deposits were placed in August to limit the impact should this arise. **If the Bank Rate falls to 0.1%, income for year as a whole is likely to fall below budget by some £20,000**.

1.4.9 In autumn 2015, there was an expectation that the economy would grow at a reasonable pace throughout 2016 and beyond. Whilst those expectations were dented in January and February 2016 by stock market falls around the world, the next move in Bank Rate, pre the referendum, was a clear expectation that it would increase. The forecast presented to Audit Committee in January anticipated Bank Rate moving from 0.5% to 0.75% mid-2016 and that rise and others feature in the Council's current financial projections. Whilst the August rate cut and the potential for a second has limited impact on investment income this financial year, the impact over the course of the next few years will be significant. Measures to mitigate some of that impact are explored in paragraphs 1.8.3 and 1.8.4.

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 in **[Annex 3]**. The graph shows the return (vertical scale) vs. the credit / duration risk (horizontal scale) associated with an authority's investments. As at 30 June 2016 our return at 0.8% (purple diamond) was above the average of 0.72% 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 just above average.

1.6 Use of Borrowing

1.6.1 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 2016/17 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 to July 2016.

1.7 Compliance with the Annual Investment Strategy

1.7.1 Throughout April to July 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.

1.7.2 In addition the Council has operated within the treasury limits and prudential indicators set out in the 2016/17 Annual Investment Strategy and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found in **[Annex 4]** to this report.

1.8 Review of Risk Parameters

1.8.1 Members will recall the detailed consideration that was given to the 2016/17 Annual Investment Strategy at the January 2016 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 2016/17 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.

1.8.2 A change in Capita's use of Credit Default Swap (CDS) data in November 2015, coupled with volatility in UK Bank CDS prices in the run-up to the referendum, resulted in a number of term deposits due to be placed in March and April of this year being delayed. Audit Committee in June supported an amendment to the Annual Investment Strategy to allow officers, under certain circumstances, to set Capita's post CDS duration assessment to one side and base term deposit duration on credit ratings alone. **In undertaking this review no further changes that impact on the Council's risk appetite are proposed**.

1.8.3 The cut in Bank Rate in August and the potential for a further cut in the autumn, will result in a significant reduction in investment income over the next few years. The majority of the Council's investment is with UK institutions. Whilst their credit quality is good, investment duration, even including the additional flexibility referred to above, is typically limited to nine months. Higher quality foreign banks are used when the opportunity arises but Capita's duration assessment invariably limits investment with them to no more than twelve months. Longer duration investments carry higher risk and are rewarded by higher returns. **A review of Capita's duration assessments will be undertaken as part of the preparatory work for the 2017/18 Annual Investment Strategy**.

1.8.4 The Council's long term cash balances will also be reviewed to identify if scope exists to use alternative types of investment e.g. property funds. Property fund Investment typically implies a minimum 5 year period to recoup initial management fees but they do offer the potential for much higher returns. The Council's cash balances are required to meet payment obligations in the short term and the Council's reserves are being consumed over the medium term whilst the Council grapples with savings targets. As a consequence, surplus monies are likely to be limited. However, even a modest investment in a property fund will help mitigate some of the impact of an extraordinarily low Bank Rate. Property funds might also be appropriate for ‘new money’ the Council was able to generate from the sale of existing land and buildings. **A detailed explanation of the risks and rewards associated with property funds will be reported to the January 2017 meeting of Audit Committee**.

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.

1.9.2 This mid-year review report fulfils a requirement of the Chartered Institute of Public Finance & Accountancy’s Code of Practice on Treasury Management 2009.

1.10 Financial and Value for Money Considerations

1.10.1 The Bank Rate having remained at a historic low of 0.5% for over 7 years was cut to 0.25% in August 2016. Capita, our treasury advisors, anticipate the bank rate will remain at this level until June 2018. However, dependent on actual economic activity over the next few months the BoE may introduce a further cut in Bank Rate in the autumn. Under this scenario Capita forecast Bank Rate dropping to 0.1% and only rising to 0.25% in June 2018.

1.10.2 At the end of July 2016, Investment income is £13,700 more than expected. If the Bank Rate remains at 0.25% throughout this financial year, income for the year as a whole is expected to be in-line with budget at £206,000. Should a further cut in bank rate take place, income is projected to fall below budget by £20,000.

1.10.3 The impact of the August Bank Rate cut and the potential for it to be cut again will have a significant impact on the Council’s ability to generate investment income over the next few years. The potential to mitigate some of that impact through alternative types of investment e.g. property funds will be explored and reported to the January 2017 meeting of Audit Committee.

1.10.4 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. At the end of June 2016 the Council’s return was above the average for all other local authorities.

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. There is no perceived impact on end users.

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 the period April to July 2016.

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

3) Note the review of the Council's long term cash balances and the use of property funds for subsequent consideration by the Audit Committee in January 2017.

Background papers: contact: Mike Withey

Capita Interest Rate Forecast (July 2016 and August 2016)

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