TONBRIDGE & MALLING BOROUGH COUNCIL

CABINET

31 January 2017

Report of the Director of Finance &Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT AND ANNUAL INVESTMENT STRATEGY 2017/18

1.1 The report details investments undertaken and returns achieved in the first nine months of the current financial year. The use of property funds for long term investment is explored and their inclusion in the 2017/18 Treasury Management and Annual Investment Strategy is recommended. Members are invited to recommend adoption of the Strategy to Council.

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 for borrowing and to prepare an Annual Investment Strategy. The latter sets 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 4]** to this report.

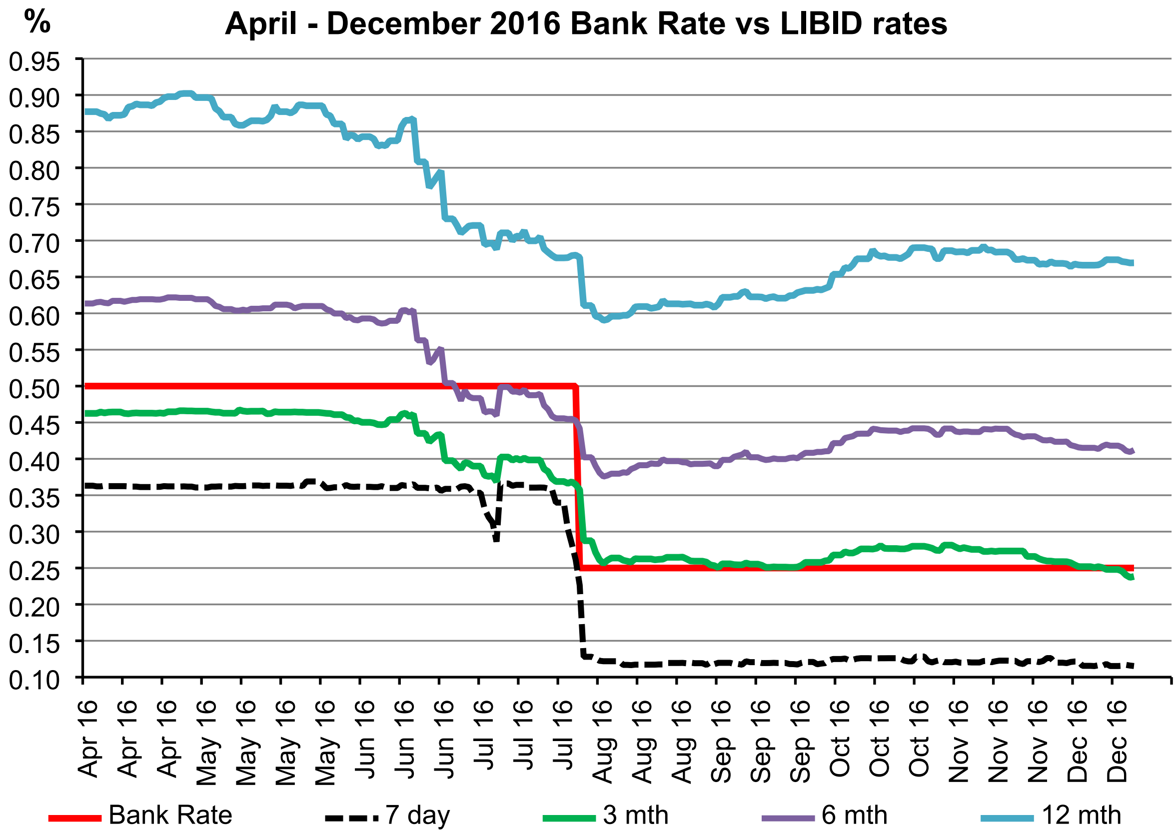
1.1.4 The portfolio of the Audit Committee includes the review of treasury management activities. Accordingly, that Committee was asked to review the matters covered by this report and **[Annex 4]** on 23 January 2017. Due to timing issues it will be necessary to verbally report upon any recommendations 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 31 January.

1.2 Treasury Management Update

1.2.1 Having satisfied security and liquidity requirements, the Council aims to optimise the yield on its investments. Since the 2008 financial crisis yields have been low reflecting the 0.5% Bank Rate introduced in March 2009. The Bank Rate having remained at 0.5% for seven years was reduced to 0.25% in August 2016. The reduction by the Bank of England was accompanied by other initiatives to help bolster economic activity which included ‘Term Funding’. The impact these measures have had on investment rates is demonstrated in the chart below.

1.2.2 Twelve month LIBID, which is indicative of the return one can expect from a one year deposit with a bank or building society, has fallen from circa 0.9% before August 2016 to only 0.65% now. This represents a reduction of some 27% and is mirrored in the returns available for shorter duration investments. Capita’s current interest rate forecast anticipates Bank Rate remaining at 0.25% until June 2019 when it is expected to rise.



Source: Capita

1.2.3 Funds available for investment comprise two distinct elements, cash flow surpluses and core cash.

1.2.4 Cash flow surpluses are available on a temporary basis and the amount mainly dependent on the timing of council tax and business rates collected and their payment to precepting authorities and government. Less significant cash flows relate to receipt of grants, payments to housing benefit recipients, suppliers and staff. Cash flow surpluses build up during the course of a financial year and are spent by financial year end. Thus far in 2016/17 cash flow surpluses have averaged £15.5m.

1.2.5 The Authority also has £23m of core cash balances. These funds are for the most part available to invest for more than one year, albeit a proportion is usually transferred to cash flow towards the end of the financial year to top-up daily cash balances. Core cash includes the Council's capital and revenue reserves which are being consumed over time to meet capital expenditure and 'buy time' to enable the authority to deliver its revenue savings targets. The core cash balance has risen since the start of the financial year and includes funds to meet business rate appeals which are expected to be resolved in 2017/18 and 2018/19.

1.2.6 A full list of investments held on 31 December 2016 is provided at **[Annex 1]** and a copy of our lending list of the same date is provided at **[Annex 2]**. The table below provides a summary of funds invested and interest earned at that date.

	Funds invested at 31 Dec 2016 **£m**	**Average duration to maturity** **Days**	**Weighted average rate of return** **%**	**Interest earned to 31 Dec 2016** **£**	**Gross annualised return** **%**	**LIBID benchmark (average since 1 April)** **%**
Cash flow	16.3	15	0.55	74,850	0.64	0.23 (7 Day)
Core cash	23.0	110	0.66	102,950	0.73	0.34 (3 Month)
Total	39.3	71	0.61	177,800	0.69	0.29 (Average)

1.2.7 Interest earned of £177,800 is £22,900 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 40 basis points. The additional income is attributed to higher than expected cash flow and core cash balances at the start of the financial year and the opportunity that this created to invest more funds in higher yielding term deposits. Every opportunity to invest in term deposits in advance of the June referendum was taken (£18m in term deposits at the end of June 2016 compared to £16m June 2015).

1.2.8 The pattern of income generation has changed significantly following the August Bank Rate cut and it is expected that the majority of £22,900 additional income will be eroded by the end of the financial year (31 March 2017). Existing term deposits will either have matured and be retained in deposit accounts / money market funds to meet spending needs or where reinvested in new term deposits, returns will be at the lower rates indicated in paragraph 1.2.2. The 2016/17 revised estimate assumes the same level of investment income as the original estimate at £206,000. A good result given the Bank Rate cut.

1.2.9 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 3]**. The graph shows the return (vertical scale) vs. the credit / duration risk (horizontal scale) associated with an authority's investments. At 30 September 2016, our return at 0.68% (purple diamond) was above the local authorities' average of 0.62% and relative to the Council's exposure to credit /

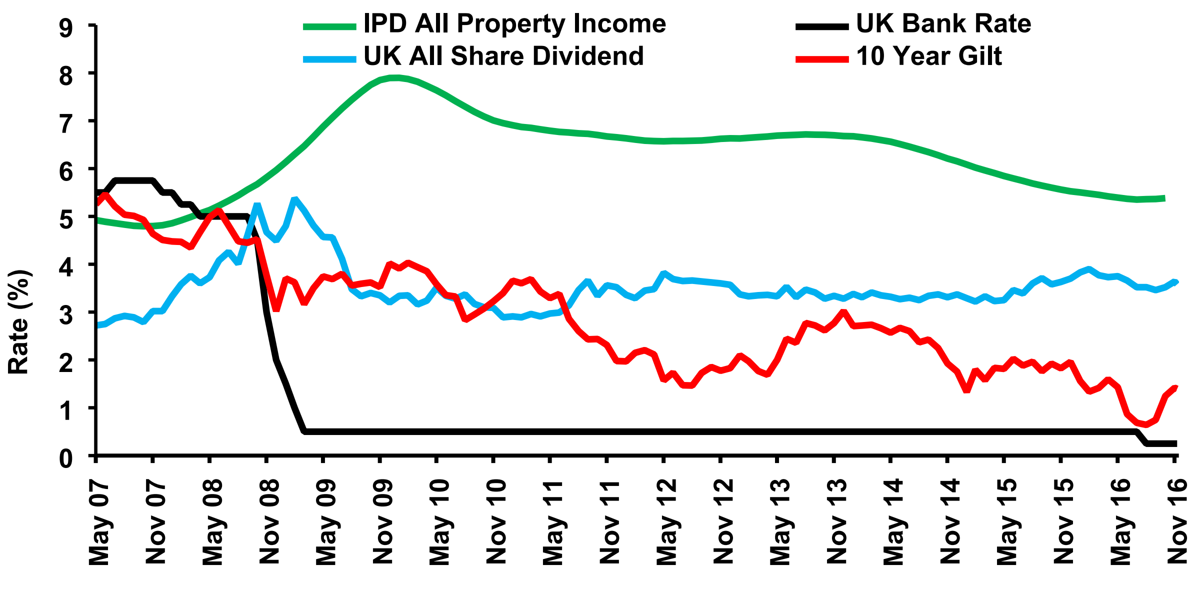
duration risk that return was at the upper end of Capita's predicted return (just below the upper boundary indicated by the green diagonal line). The Council's risk exposure was slightly above the local authorities' average. As Members will recall from previous treasury reports the result is typical of the enhanced performance achieved following the transfer of all core cash investments to in-house management in August 2014.

1.3 Treasury Management and Annual Investment Strategy for 2017/18

1.3.1 In response to actual and anticipated reductions in revenue support from Government, the Council is progressing a Savings and Transformation strategy. Part of that strategy includes identifying new income streams and enhancing existing ones where feasible. The Treasury Management report to Audit Committee in September explained that rather than a cut in Bank Rate our financial projections (presented to Council last February) had assumed the next move in Bank Rate would be an increase. The report also explained that whilst the August cut would have little impact on investment income relative to budget this financial year, the impact over the medium term was likely to be significant. A number of actions were identified to mitigate some of that impact: explore the risks and benefits associated with long term investment, review cash balances that might be available for such an investment and; review term deposit investment duration.

1.3.2 **Long term Investment**. Investment in equities, bonds or property is expected to produce an annual income stream and over time, capital appreciation. Whilst the income stream (dividends, interest or rents) will be received at regular intervals during the year any capital appreciation will only be realised when the investment is redeemed. Subject to an understanding and acceptance of the risks, reducing the Council's current revenue shortfall is best served by selecting the asset class that maximises income.

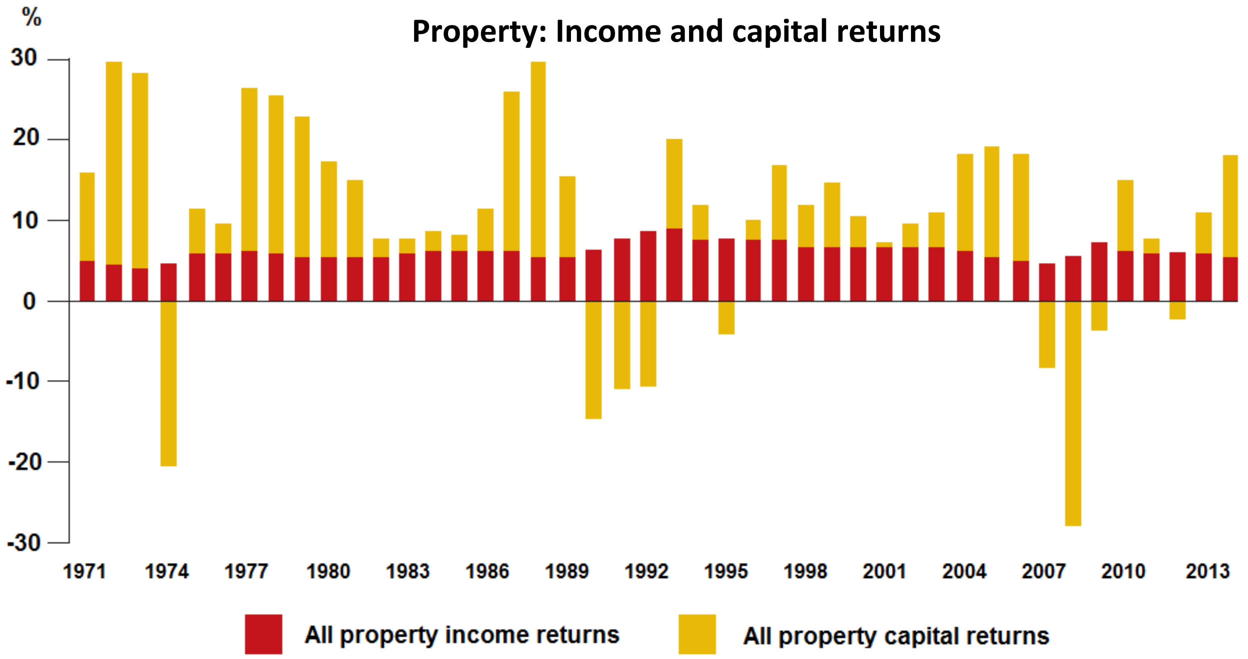
Income return across different asset classes



Source: Capita

1.3.3 In the ten years to November 2016 the annual income from property averaged 6.3% and dividends from equities averaged 3.5%. Interest from Gilts has shown greater variability (influenced by interest rate and inflation expectations) but in the last five years has averaged 1.9%. Purely from an income perspective property is an obvious choice.

1.3.4 Whilst the rental income from property is relatively stable, capital appreciation and depreciation exhibits a strong correlation to GDP. When the economy is in decline (recession) the capital value of property can fall significantly (-20% in 1974; -35% in 1990 to 1992 and; -40% in 2007 to 2009).



Source: MSCI, as included in 'Understanding UK Commercial Property Investments' published by the Investment Property Forum (IPF) 2015

1.3.5 Acquiring a property, whether directly or indirectly through participation in a fund, involves a significant outlay in taxes (mainly stamp duty), legal and other fees. Selling property also involves fees and takes time. Both sets of cost result in high entry and exit fees, circa 6% and 2% respectively, which means property investment is only viable if those costs can be spread over a number of years (minimum of five years). At some point during the investment a fall in capital value may arise from a downturn in the economy reducing the overall net gain from the investment if it were redeemed or delay redemption to avoid incurring a loss. A property investment is only appropriate if **one accepts and can tolerate the volatility in capital value; is able to invest over a lengthy period of time and; can be flexible about the timing of any redemption in the future**.

1.3.6 Ordinarily investment in property would be classified as capital expenditure. Essentially this means that any sums invested would need to feature in the authority's capital plan and redemption in the future would be deemed a capital receipt. Capital receipts can only be applied to repay borrowing (the Council is debt free) or fund new capital expenditure. However, investment in a number of property funds can be treated as revenue expenditure under the Local Authorities

(Capital Finance and Accounting)(Amendment)(England) Regulations 2010 where the investment scheme is an investment scheme approved by the Treasury under section 11(1) of the Trustee Investments Act 1961 (local authority investment schemes).

1.3.7 The Authority currently has a core cash balance of £23m (paragraph 1.2.5 above) which includes the general revenue reserve and capital reserve. The lion's share of these reserves is being consumed over the next few years to assist the Authority achieve a balanced budget. The Council's medium term financial strategy (MTFS) which is used to identify savings targets is constructed using a number of criteria. One of which is to maintain a minimum general revenue reserve balance of at least £2m throughout the ten year period of the MTFS. Through good financial management, the Authority generally delivers a small surplus against budget at year-end. Those surpluses are invariably used to create earmarked reserves to meet a specific purpose or applied to existing reserves to support expenditure more generally. The Council also receives capital funding on an ad-hoc basis by way of developer contributions. Whilst year-end surpluses / external funding can't be relied upon (hence we don't budget for them) they do represent an opportunity to use some or all of the minimum general revenue reserve balance for a property fund investment. The ten year period of the MTFS and its regular review, provides the opportunity to undertake a long-term investment and signal the timing of a partial or full redemption in the future. The impact of the 2017/18 Local Government Finance Settlement will need to be factored into the assessment of how much of the minimum general revenue reserve balance can be invested and will be determined as we progress through the current budget setting process.

1.3.8 There are numerous property funds available that have: a track record that precedes the 2008 financial crisis; a diverse property portfolio (mix of retail, office and industrial / warehouse premises); a portfolio in excess of £500m; a client base of over 50 investors and; where investment is not classified as capital expenditure. The detailed analysis required to identify the most appropriate fund will be time consuming and is likely to span several months to complete. Whilst this can be undertaken in-house there is merit in engaging our current treasury advisor to assist with the process. Capita offer a fund selection service covering fund investment strategies; performance analysis; portfolio composition; liquidity risk and; fee analysis. The research results in a short list of funds that meet our criteria and who can then be invited for interview prior to a final decision being made.

1.3.9 Capita have reviewed the text at paragraphs 1.3.2 to 1.3.5 above and comment: income from 'property is less volatile than shares and greater value than gilts and is an asset class that is suitable for local authorities to diversify into, if they do not already have a large property estate on balance sheet'. If Members support a property fund investment the 2017/18 estimates will need to be amended (at the revised estimate stage) to reflect the additional income that can be anticipated (circa £40,000 per annum per £1m invested) and a one-off addition to the external fees budget (circa £7,500). The Annual Investment Strategy will also need to be amended to permit investment in a non-credit rated property fund and establish a cash limit for such investments (paragraph 1.3.15, bullet point 8).

1.3.10 Whilst investment would most likely take place early in the new financial year the timing would be influenced by market reaction to the triggering of Article 50 (expected before the end of March 2017) and other macro and global economic developments.

1.3.11 **Term deposit 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 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. 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.

1.3.12 In response to interpretational issues around the use of CDS data by our treasury advisors, a more flexible approach to Capita's duration assessment was introduced in the 2014/15 Annual Investment Strategy. The strategy allowed up to three months to be added to Capita's suggested 'post CDS duration' for UK institutions (e.g. a nine month term deposit could be placed against a Capita suggested duration of six months).

1.3.13 The discretion has been used on numerous occasions over the last three years. Its use in the current financial year is detailed in **[Annex 1]** by comparing the figures in 'Capita's Suggested Post CDS Duration' column with those in the actual 'Investment Duration' column. The use of that discretion is also a contributory factor to the Council's above average performance revealed in the quarterly benchmarking data **[Annex 3]**. That data also measures the Council's exposure to risk (combination of duration and credit quality) which generally hovers around the local authorities average each quarter. There is scope to increase the Council's exposure to duration risk yet still remain close to our peer average.

1.3.14 Where the rate on offer by a UK bank is considered exceptional relative to other UK Banks and provided the market perception of risk attributed to the bank is below the average CDS for all other banks, the 2017/18 strategy (paragraph 1.3.15, bullet point 5) allows up to six months to be added to Capita's post CDS duration assessment. The combined duration (Capita's suggestion plus the six month discretion) must not exceed twelve months in total. Where the 'added' flexibility is applied, counterparty exposure will also be reduced from the standard

20% to 10%. These exceptions will ensure the added flexibility can only be applied to a small proportion of the investment portfolio.

1.3.15 **Risk parameters**. The strategy sets out the parameters that 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. Except where indicated by ***bold italic*** text, the 2017/18 Annual Investment Strategy **[Annex 4]** adopts the same risk parameters as currently approved. In summary these are :

- 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 for overnight deposits and deposits up to 2 years in duration, 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 (based on credit ratings alone). 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 post CDS recommendation. For UK financial institutions Capita's duration recommendation can be enhanced by up to ***six*** months subject to the combined duration (Capita recommendation plus the enhancement) not exceeding 12 months. The Council's Treasury Management Practices will be modified to ensure that: where duration is being enhanced by more than three months the bank's CDS must be below the average for all other banks at the time of placing the investment; the discretion is only to be applied to take advantage of an exceptional offer and; counterparty exposure in respect of the additional enhancement (plus 6 months instead of the standard plus three months for a UK institution) will be limited to 10% of cash flow/core cash.

- 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.

- ***Exposure to non-credit rated property funds is limited to no more than 40% of available cash balances (20% limit per fund). No limit applies***

where invested funds are derived from new resources i.e. proceeds from selling existing property.

- The strategy also limits the type of instrument (e.g. fixed term deposits, certificates of deposit, commercial paper, floating rate notes, treasury bills, etc.) that can be used and establishes a maximum investment duration for Gilts of 10 years and 2 years for all other types of investment other than property.

1.3.16 At the present time an appropriate level of diversification is achieve through access, both directly and via brokers, to an adequate number of high credit rated financial institutions. Our cash flow forecasting aims to ensure the Council has sufficient liquidity to meet payment obligations at all times. Excess liquidity is avoided by using term deposits and other instruments to generate additional yield when daily cash surpluses permit. Cash flow surpluses can and are transferred to core cash to enable longer duration investments to be undertaken than would otherwise be the case.

1.3.17 The 2017/18 Strategy **[Annex 4]** reflects the current economic environment, Capita's latest interest rate forecast and incorporates the risk parameters summarised in paragraph 1.3.15.

1.4 MiFID II

1.4.1 The Financial Conduct Authority (FCA) consultation on proposals to implement the European Union's second Markets in Financial Instruments Directive (MiFID II) ended on 4 January. The directive impacts on the way local authorities access financial services provided by banks, advisors, brokers and fund managers.

1.4.2 Under the existing directive the Council enjoys 'professional client' status. Under MiFID II, all local authorities will be reclassified as 'retail clients' (the same as a private individual) but will be able to opt-up to professional status if they meet certain quantitative and qualitative criteria. The proposed quantitative threshold for opt-up is a financial instruments portfolio exceeding £15m. The limit, intended to exclude parish and town councils from the opt-up, will also exclude a significant number of district councils.

1.4.3 At the present time the value of the Council's portfolio is substantially higher that the proposed threshold. However, our projected use of both revenue and capital reserves is likely to see our balances dip below the threshold in a few years' time. A response to the FCA's consultation questions is provided at **[Annex 5]**.

1.5 Money Market Fund Reform

1.5.1 A press release, issued in November, announced the European Parliament, Commission and Council, after lengthy negotiation, had agreed regulatory changes to Money Market Funds (MMFs) operating in the European Union (i.e. those used by this Council). 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 AAA credit rated product and; ensure our peak monthly cash balances are disbursed across a broad range of counterparties.

1.5.2 The regulatory changes include provision for a new class of LNAV (low volatility) fund to be created which will most likely be used by fund providers to replace the existing CNAV (constant net asset value) funds use by the Council. The new funds will be subject to redemption fees and or restrict redemptions at times of heightened market stress. It is expected that the LNAV funds will continue to be credit rated by the rating agencies. Fund providers will need to comply with the regulatory changes during the second half of 2018. Whilst change is inevitable it is unlikely to impact on our cash management operation during 2017/18. Members will be updated as fund providers developed their responses to the regulatory changes allowing us to evaluate the associated risks.

1.6 Legal Implications

1.6.1 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.

1.6.2 This report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009 and subsequent updates.

1.7 Financial and Value for Money Considerations

1.7.1 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 2019.

1.7.2 At the end of December investment income for 2016/17 is £22,900 better than budget for the same period. However, the August Bank Rate cut, together with other measures introduced by the Bank of England, has had a significant downward impact on investment returns going forward. As a consequence, investment income for the 2016/17 financial year as a whole is expected to return to budget at £206,000.

1.7.3 Following the Bank Rate cut, income for 2017/18 and over the medium term will be significantly lower than anticipated in the financial projections presented to Council in February 2016. Investment income for 2017/18 is now forecast to be £126,000 compared to £296,000 (February 2016).

1.7.4 The enhanced income from a property fund investment will mitigate some of the impact a lower Bank Rate will have on investment income. Whilst the annual income stream from property exhibits stability, capital values rise and fall with the cyclical nature of economic activity. During a downturn in the economy capital values may fall significantly. As a consequence the duration of a property based investment cannot be determined with certainty.

1.7.5 Investment performance is monitored against relevant benchmarks and compared to other local authorities using benchmarking data provided by Capita.

1.8 Risk Assessment

1.8.1 Capita are employed to provide advice on the content of the Treasury Management 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.

1.8.2 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 are established to ensure an appropriate level of diversification.

1.8.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2017/18 Strategy have been minimised.

1.9 Equality Impact Assessment

1.9.1 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.

1.10 Recommendations

1.10.1 Members are invited to **RECOMMEND** that Council:

1) note the treasury management position as at 31 December 2016;

2) endorse the use of property funds for long term investment;

3) subject to the caveats identified in paragraph 1.3.14 allow up to six months to be added to Capita's suggested duration for UK institutions, subject to overall duration not exceeding 12 months;

4) adopts the Treasury Management and Annual Investment Strategy for 2017/18 set out at **[Annex 4]**.

Background papers: contact: Mike Withey

Capita Interest Rate Forecast (November 2016) and Economic Commentary

Sharon Shelton
Director of Finance & Transformation