TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

03 July 2017

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2016/17

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 2016/17 is also included in this report.

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 Despite the recent improvements in public finance data and healthier near term economic outlook the Chancellor's spring budget introduced no major changes in government policy. The main focus areas for support were the NHS and social care, education and additional funds earmarked for businesses to assist with planned changes in business rates.

1.2.2 The budget was supported by updated economic growth and inflation forecasts by the Office for Budget Responsibility (OBR). The GDP forecast for 2016/17 was confirmed at 2.0%, increased to 1.8% for 2017/18 (1.3% last autumn) but reduced in subsequent years (now 1.6% in 2018/19 rising back to 2.0% in 2021/22). The Consumer Price Index forecast was confirmed at 1.0% for 2016/17, rising to 2.6% in 2017/18 and falling back to 2.0% in 2019/20. Since the spring budget, CPI has risen to its highest reading over the last four years to 2.9% for the 12 months ending May 2017.

1.2.3 In the February Inflation Report, the Bank of England moved to a 'neutral' policy position, stating that central bank policy can respond in 'either direction' to changes in the economic outlook, removing its previous view that a rate cut was likely. At the Bank's March meeting, the minutes noted 'it would take relatively little further upside news on the prospects for activity or inflation for them to consider that a more immediate reduction in policy support might be warranted'. The March meeting also saw one of its nine members vote for an immediate increase in Bank Rate. The June meeting saw three members vote for an increase.

1.2.4 In America the Federal Reserve raised the Fed Rate (equivalent of our Bank Rate) by 0.25% to 0.75% in December 2016. The rise, the second since 2006, was accompanied by an expectation that further rises would follow in 2017. The March meeting saw the Fed Rate increase by a further 0.25% to 1.00% and increase again by a further 0.25% at the June meeting.

1.2.5 The outcome of the General Election has added to market uncertainty surrounding the Brexit negotiations which commenced in June.

1.3 Interest Rate Forecast

1.3.1 The Bank Rate, having remained at an emergency level of 0.5% for over seven years, was reduced to 0.25% in August 2016. Capita, the Council's treasury advisor, provided an updated forecast in May 2017. The forecast anticipates the Bank Rate remaining at 0.25% until June 2019.

Rate	Now %	Sep-17 %	Dec-17 %	Mar-18 %	Jun-18 %	Sep-18 %	Dec-18 %	Mar-19 %	Jun-19 %	Sep-19 %	Dec-19 %	Mar-20 %
Bank Rate	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.50**	**0.50**	**0.75**	**0.75**
3 mth LIBID	**0.19**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.40**	**0.50**	**0.60**	**0.70**	**0.80**	**0.90**
6 mth LIBID	**0.33**	**0.40**	**0.40**	**0.40**	**0.40**	**0.40**	**0.50**	**0.60**	**0.70**	**0.80**	**0.90**	**1.00**
12 mthLIBID	**0.54**	**0.60**	**0.70**	**0.70**	**0.80**	**0.80**	**0.90**	**1.00**	**1.10**	**1.20**	**1.30**	**1.40**
25yr PWLB	**2.60**	**2.80**	**2.90**	**2.90**	**3.00**	**3.00**	**3.10**	**3.10**	**3.20**	**3.20**	**3.30**	**3.30**

1.4 Investment Performance

1.4.1 In accordance with the CIPFA Code the Council's priorities, in order of importance, are: to ensure security of capital; liquidity; and having satisfied both, to obtain an appropriate level of return which is consistent with the Council's risk appetite.

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

1.4.3 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 precept 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 **[Annex 1]**. Thus far in 2017/18 cash flow surpluses have averaged £10.5m.

1.4.4 The Authority also has £22m 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 also includes some £8m to meet business rate appeals which are expected to be resolved in 2017/18 and 2018/19.

1.4.5 A full list of investments held on 26 May 2017 is provided at **[Annex 2]** and a copy of our lending list of the same date is provided at **[Annex 3]**. The table below provides a summary of funds invested and interest earned at 31 May 2017.

	Funds invested on 31 May 2017 £m	**Average duration to maturity Days**	**Weighted average rate of return %**	**Interest earned to 31 May 2017 £**	**Gross annualised return %**	**LIBID benchmark (average from 1 April 2017) %**
Cash flow	9.3	33	0.43	7,150	0.40	0.11 (7 Day)
Core funds	22.0	137	0.67	25,750	0.67	0.20 (3 Mth)
Total	31.3	106	0.60	32,900	0.59	0.17 (Ave)

1.4.6 Interest earned of £32,900 to the end of May is £12,050 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 42 basis points. The additional income is in part due to the higher core fund balance attributed to business rate appeal provisions.

1.5 Benchmarking

1.5.1 The Council takes advantage of Capita's benchmarking service 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 2017 our return at 0.64% (purple diamond) was above the local authority average of 0.55%. Based on the Council's exposure to credit / duration risk that return was in-line with Capita's predicted return (just below the upper boundary indicated by the green diagonal line). The Council's risk exposure, whilst above average, was not excessive relative to others.

1.6 Compliance with the Annual Investment Strategy

1.6.1 Throughout April and May 2017 all of the requirements contained in the 2017/18 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 2017.

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 2017 meeting of Audit Committee.

1.7 Long Term Investment Update

1.7.1 The availability of cash balances over the longer term (10 years) and the suitability of different types of long term investment (equities, bonds and property) was explored in the report to Audit Committee, January 2017. Of the alternatives, investment in property funds was considered the most appropriate. The use of property funds for both existing cash balances and any new money derived from the sale of assets was subsequently approved by Council in February 2017.

1.7.2 There are numerous property funds to choose from. Many have: a track record that precedes the 2008 financial crisis; a diverse **commercial 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. Capita were engaged to assist with the detailed analysis required to identify the most appropriate funds to suit the Council’s needs. That assistance included analysis of: fund investment strategies; performance; portfolio composition; liquidity risk and fund management fees.

1.7.3 The analysis produced a shortlist of four funds who were invited to attend an interview at the Council’s offices in late May. The interviews with fund managers provided the opportunity to probe in more detail their differing investment strategies and portfolio mix. The process culminated in three funds being selected for immediate investment.

1.7.4 £2m of the Council’s existing cash balance has been identified for long term investment and is to be applied to investment in property funds. A further £1m anticipated from the disposal of existing property assets is also being applied now, bringing the total available for investment to £3m. Applications have been submitted and accepted by each of the: Local Authorities Property Fund; Hermes Property Unit Trust and the Lothbury Property Fund. Investment is to be diversified across the three funds to ensure, as far as is possible, stability of annual income and capital growth overtime. £1m is to be applied to each fund with investment expected to commence at the end of June 2017.

1.8 2016/17 Treasury Management Outturn

1.8.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 28 June 2017 as an annex to the Revenue and Capital Outturn report for 2016/17. That annex is replicated in full and provided at **[Annex 5]** to this report. The role of this Committee is to act as scrutineer on behalf of full Council.

1.8.2 A summary of the investment performance included in Annex 5 is as follows:

2016/17 Financial Year	Average investment £m	Gross rate of return %	Interest earned £	Original / revised estimate £
Cash flow	16.0	0.57	91,500	82,000
Core funds	19.8	0.71	140,000	124,000
Total	35.8	0.65	231,500	206,000

1.8.3 The combined performance of the Authority's cash flow and core funds bettered the original / revised estimate by £25,500.

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 Investment income at the end of May 2017 (month two of the financial year) is £12,050 better than budget for the same period. Income for the 2016/17 financial year as a whole exceed budget by some £25,500.

1.10.2 The Bank Rate having remained at a historic low of 0.5% for over seven 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.

1.10.3 Performance is monitored against a benchmark return and against other local authorities in Kent and the broader local authority pool via Capita's benchmarking service.

1.10.4 Whilst the annual income stream from a property fund exhibits stability (circa 4.5% per annum net of management fees) 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.

1.10.5 Buying and selling property involves significant costs making property unsuitable for short term investment. Buying and selling costs are reflected in the entry fees (circa 6%) and exit fees (circa 2%) a property fund will charge unit holders. These fees are expected to be recouped overtime through capital appreciation.

1.10.6 The money being applied to property fund investment from existing resources is expected to be available in perpetuity. Nevertheless, the Council's cash balances will continue to be monitored and due regard had to the potential for a fund to delay payment of redemption requests by up to 12 months. Funds will seek to minimise their own cash balances in favour of holding property and therefore manage redemption requests for the benefit of all fund participants. The Council is only likely to seek redemption to pursue a higher yielding income opportunity should one be identified.

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 an 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 Council:

1) Endorse the action taken by officers in respect of treasury management activity for April and May 2017.

2) Note the progress being made in respect of property fund investment.

3) Note the 2016/17 outturn position.

Background papers: contact: Mike Withey

Capita interest rate forecast (May 2017)
Capita benchmarking data (March 2017)

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