

**TONBRIDGE & MALLING BOROUGH COUNCIL**

**AUDIT COMMITTEE**

**04 September 2017**

**Report of the Director of Finance and Transformation**

**Part 1- Public**

**Matters for Recommendation to Cabinet – Council Decision**

**1 TREASURY MANAGEMENT UPDATE AND MID-YEAR REVIEW**

**The report provides an update on treasury management activity undertaken during April to July of the current financial year. A mid-year review of the Treasury Management and Annual Investment Strategy for 2017/18 is also included in this report.**

**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 2017/18 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2017/18.
- Long term investment update.
- A review of the risk parameters contained in the 2017/18 Annual Investment Strategy.

## **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. GDP was forecast at 2.0% for 2016/17, 1.8% for 2017/18 (up from 1.3% forecast last autumn), 1.6% for 2018/19 and rising back to 2.0% in 2021/22. The Consumer Price Index forecast was 1.0% for 2016/17, rising to 2.6% in 2017/18 and falling back to 2.0% in 2019/20.

1.2.3 Since the spring budget, CPI has risen to 2.9% for the 12 months to May 2017, its highest reading in four years. Although CPI dropped to 2.6% for the 12 months ending July some economists expect inflation to increase again as a result of the falling pound causing the cost of imported goods to rise. RPI for the 12 months to July was 3.6%.

1.2.4 Unemployment fell to a 42 year low of 4.5% in July. Whilst positive news, average weekly earnings after adjusting for inflation fell by 0.7%.

1.2.5 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 (post the Brexit referendum and the August 2016 rate cut) that a further 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 August meeting saw two members vote for an increase.

1.2.6 At the Bank of England's August meeting the scale of the Term Funding Scheme (provision of cheap finance to banks introduced in August 2016) was increased from £100bn to £115bn. The February 2018 end date for the scheme was also confirmed.

1.2.7 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. Thus far in 2017 the Fed Rate has been increased by a further 0.25% in March and again in June and now stands at 1.25%. Growth accelerated to 2.6% in the 12 months to June 2017 (compares with 1.7% for the UK).

### 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 August 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 mth LIBID	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 The Council's investments are derived from cash flow surpluses, core cash and other long term cash balances.

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. Thus far in 2017/18 cash flow surpluses have averaged £12.3m.

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 The Council's long term cash balances were reviewed autumn 2017. The review concluded that up to £2m of the Council's existing cash balances and any 'new money' derived from the sale of assets could be applied to a long term investment. Of the alternatives, property funds were considered best suited to meet the Council's more immediate funding needs. Property fund investments of £2m are included in the table below and discussed in greater detail later in the report (Section 1.7).
- 1.4.6 A full list of investments held on 31 July 2017 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 31 July 2017.

	<b>Funds invested on 31 July 2017</b>	<b>Average duration to maturity</b>	<b>Weighted average rate of return</b>	<b>Interest / dividends earned to 31 July 2017</b>	<b>Annualised return</b>	<b>LIBID benchmark (average from 1 April 2017)</b>
	<b>£m</b>	<b>Days</b>	<b>%</b>	<b>£</b>	<b>%</b>	<b>%</b>
Cash flow	10.1	66	0.49	17,150	0.42	0.11 (7 Day)
Core cash	22.0	193	0.66	48,950	0.67	0.19 (3 Mth)
<b>Sub-total</b>	<b>32.1</b>	<b>153</b>	<b>0.60</b>	<b>66,100</b>	<b>0.58</b>	<b>0.16 (Ave)</b>
Property funds	2.0			-	-	
<b>Total</b>	<b>34.1</b>			-	-	

- 1.4.7 Interest on cash flow and core cash balances of £66,100 to the end of July is £24,150 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 42 basis points. The additional income is due primarily to the higher core cash balance attributed to business rate appeal provisions.
- 1.4.8 The slowing economy and likelihood that the Bank Rate won't rise for some time to come has resulted in bank offers falling in recent months. Nevertheless, income is expected to continue above budget on a monthly basis albeit at a slower pace as the year progresses. Income for the year as a whole is likely to exceed budget by some £50,000.

- 1.4.9 Property fund investments of £2m were placed at the end of June / beginning of July 2017. A further £1m is expected to be placed by the end of September. Dividends from property funds are distributed on a quarterly basis. The next distribution is due at the end of September 2017. Any dividends received will be in addition to the current year budget provision.

## 1.5 Benchmarking

- 1.5.1 The Council takes advantage of Capita's benchmarking service which enables performance on cash flow and core cash returns 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 June 2017, our return at 0.62% (purple diamond) was above the local authority average of 0.50%. Based on the Council's exposure to credit / duration risk that return was also above Capita's predicted return (above 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 Treasury Management and Annual Investment Strategy

- 1.6.1 Throughout the period April to July 2017 all of the requirements contained in the 2017/18 Treasury Management and Annual Investment Strategy intended to limit the Council's exposure to investment risks (minimum sovereign and counterparty credit ratings; 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 to July 2017.
- 1.6.2 In addition, the Council has operated within the treasury limits and prudential indicators set out in the 2017/18 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.

## 1.7 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 Of the Council's existing cash balances £2m 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 Trust. Investment is to be diversified across the three funds to ensure, as far as is possible, stability of annual income and capital growth over time.
- 1.7.5 At the end of July 2017, £1m has been invested in the Local Authorities' Property Fund (placed June 29) and £1m invested in the Lothbury Property Trust (placed July 6). A further £1m has been earmarked for the purchase of units in the Hermes Property Unit Trust. The timing of this final investment is dependent on the fund issuing new primary units (expected August / September).
- 1.7.6 In setting the budget for the current financial year no income from property funds was anticipated. Based on recent performance by the funds and subject to the timing of the Hermes investment, net income for 2017/18 is likely to be in the region of £70,000 (£77,500 dividends less a one-off addition to treasury management consultancy fees of £7,500).

## **1.8 Review of Risk Parameters**

- 1.8.1 Members will recall the detailed consideration that was given to the 2017/18 Treasury Management and Annual Investment Strategy at the January 2017 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 2017/18 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 six months subject to the combined duration (Capita recommendation plus the enhancement) not exceeding 12 months. Where duration exceeds Capita's recommendation by more than three months, the institution's CDS must be below average at the time the investment is placed and exposure in the extended duration limited to 10% of funds.
- Money Market funds should be rated Fitch AAmmf or equivalent and exposure limited to no more than 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 limited to 20% per fund and 40% to all such funds.

1.8.2 The returns being offered by financial institution vary significantly one to another and across all durations. Whilst scope is limited from an income generation perspective there are a sufficient number of creditworthy institutions available to the Council to ensure an appropriate level of diversification. In undertaking this review **no changes to the current approved risk parameters are proposed.**

## 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 from cash flow and core cash at the end of July 2017 (month four of the financial year) is £24,150 better than budget for the same period.

Income for the 2017/18 financial year as a whole is likely to exceed budget by some £50,000.

- 1.10.2 No provision was included in the current year budget for income from property funds. Based on recent performance and subject to the timing of the final investment with the Hermes Property Unit Trust net income for the year as a whole is expected to be in the region of £70,000.
- 1.10.3 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.
- 1.10.4 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.
- 1.10.5 Whilst the annual income stream from a property fund exhibits stability (circa 4% 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. To avoid crystalizing a loss duration may need to be extended. As a consequence the duration of a property based investment cannot be determined with certainty.
- 1.10.6 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.
- 1.10.7 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 Cabinet:

- 1) Endorse the action taken by officers in respect of treasury management activity for April to July 2017.
- 2) Note the progress made in respect of property fund investments.
- 3) Retain the existing parameters intended to limit the Council's exposure to investment risks.

Background papers:

contact: Mike Withey

Capita interest rate forecast (August 2017)

Capita benchmarking data (June 2017)

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