TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

22 January 2018

Report of the Director of Finance &Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT UPDATE AND TREASURY MANAGEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2018/19

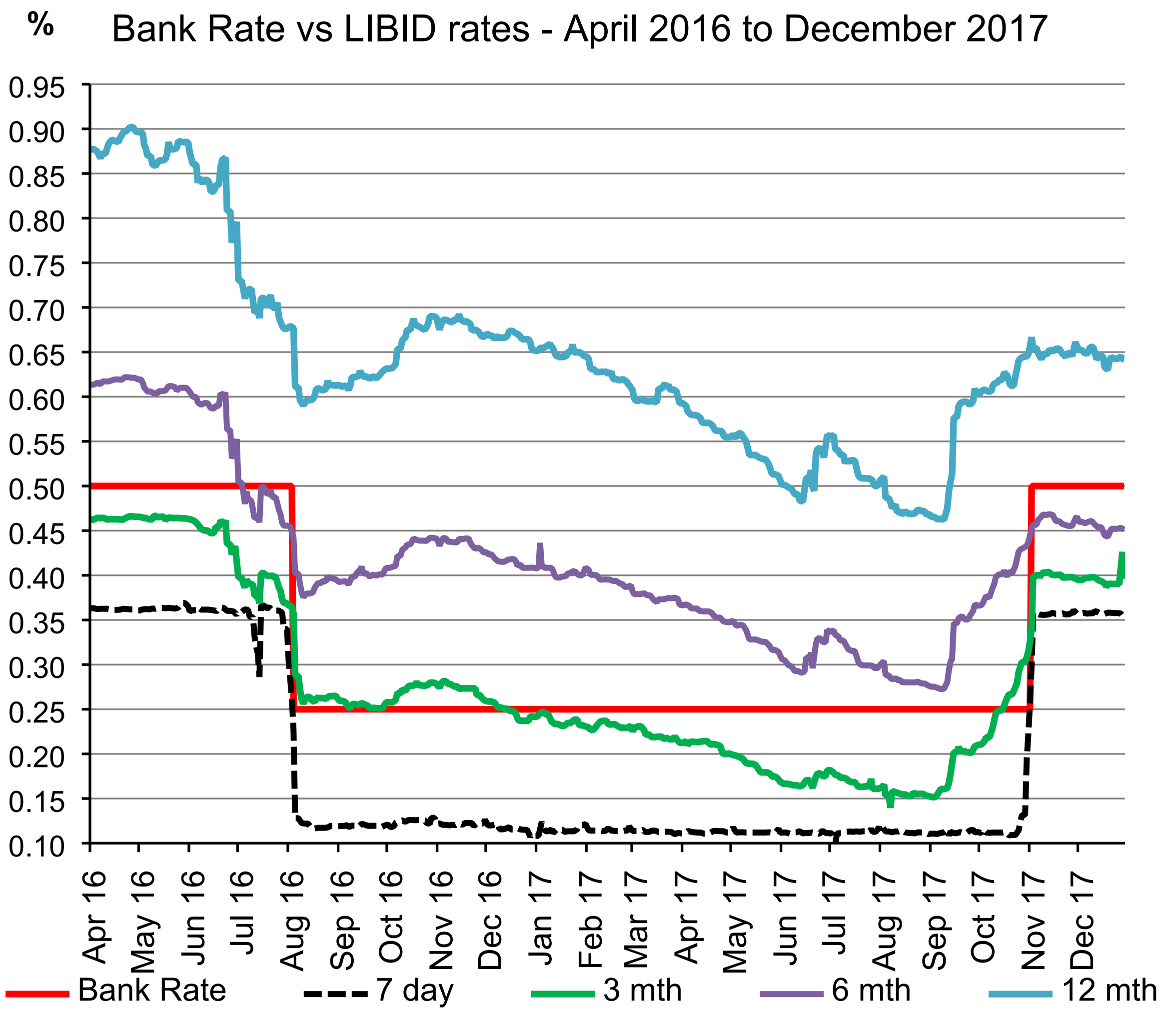
1.1 The report provides details of investments undertaken and return achieved in the first nine months of the current financial year. The report explores the use of diversified income funds for medium term investment and recommends their inclusion in the 2018/19 Annual Investment Strategy. Members are invited to recommend adoption of the Strategy to Cabinet.

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.

1.2 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' for banks. In November 2017, the Bank of England returned the Bank Rate to 0.5%. The next rise in Bank Rate is not anticipated until the fourth quarter of 2018. The impact these measures have had on investment rates is demonstrated in the chart below.



Source: Link Asset Services

1.2.2 The Council's investments are derived from cash flow surpluses, core cash balances and other long term cash balances.

1.2.3 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 £13.5m.

1.2.4 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 £6m (down from £8m at the start of the financial year) to meet business rate appeals which are expected to be resolved in the latter part of 2017/18 and during 2018/19.

1.2.5 Long term investment comprises £3m in property fund investments.

1.2.6 A full list of investments held on 31 December 2017 is provided at **[Annex 1]** and a copy of our lending list of 2 January 2018 is provided at **[Annex 2]**. The table below provides a summary of funds invested and interest earned at the end of December.

	Funds invested at 31 Dec 2017 £m	Average duration to maturity Days	Weighted average rate of return %	Interest earned April to December 2017	Gross annualised return %	LIBID benchmark (average since 1 April) %
Cash flow	16.0	27	0.56	45,000	0.44	0.11 (7 Day)
Core cash	22.0	109	0.69	113,600	0.67	0.19 (3 Month)
Sub-total	**38.0**	**75**	**0.63**	**158,600**	**0.58**	**0.16 (Average)**
Long term	3.0			38,000	3.81	
Total	41.0					

Interest on long term investments is based on dividends declared by the Local Authorities' Property Fund and the Lothbury Property Trust to end of December 2017. The Hermes Property Unit Trust dividend for the quarter October to December is not due to be declared until mid-February 2018.

1.2.7 **Cash flow and Core Cash investments**. Interest earned of £158,600 from cash flow surpluses and core cash balances to the end of December is £63,900 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.

1.2.8 Following the Bank Rate rise in November there has been a noticeable improvement in money market fund returns mirroring the improvement in short duration (sub six month) deposits with banks and building societies. Returns on six to twelve month deposits, where the bulk of the Council's investment income is achieved, has shown little improvement. Nevertheless, investment income from cash flow surpluses and core cash balances is expected to exceed the original estimate for the year as a whole by some £70,000 and this increase is reflected in the revised estimates.

1.2.9 The Council takes advantage of Link Asset Services' (formerly Capita) benchmarking facility which enables performance to be gauged against Link'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 2017, our return at 0.64% (purple diamond) was above the local authority average of 0.46% and relative to the Council's exposure to credit / duration risk that return was above Link's predicted return (above the upper boundary indicated by the green diagonal line). The Council's risk exposure was slightly above the local authority average but not excessive by comparison.

1.2.10 **Long term investment**. 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 best suited to meet the Council's more immediate funding need (a sustainable, stable income stream). 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.

1.2.11 Link Asset Services were engaged to assist with the detailed analysis required to identify the most appropriate fund(s). The analysis produced a shortlist of four funds who were invited to attend an interview at the Council's offices in late May. The process culminated in three funds being selected for immediate investment.

1.2.12 Of the Council's existing cash balances, £2m was identified for long term investment and has been applied to investment in property funds. A further £1m anticipated from the disposal of existing property assets has also being applied now, bringing the total investment in property funds to £3m. Applications were submitted and accepted by each of the: Local Authorities' Property Fund; Hermes Property Unit Trust and the Lothbury Property Trust. Investment was spread equally across the three funds to ensure, as far as is possible, stability of annual income and capital growth over time.

1.2.13 From the January Audit Committee report Members will recall that funds issue / redeem primary units at a buy / sell price with the difference between the two prices reflecting the costs associated with buying and selling a property (legal and other fees, stamp duty etc.). The price spread varies from fund to fund but is typically in the region of 8% (6% on entry to a fund and 2% on exit). Where units are traded on a secondary market the impact of the spread can be reduced and delays in the purchase or redemption of units avoided. Secondary market activity in 'quality' funds is currently both limited and when it does arise, units are traded close to the standard entry price.

1.2.14 Primary units in the Local Authorities' Property Fund (LAPF) and Lothbury Property Trust (LPT) were acquired at the end of June from the fund managers at the standard entry price. The sale value of the units acquired was valued below the £1m cash sum paid to each manager by £77,750 for LAPF and £72,300 for LPT. Units in the Hermes Property Unit Trust (HPUT) were acquired at the end of September through an auction of secondary units arranged by the fund manager.

The Council's participation in the auction delivered a saving of £7,000 against the standard entry price. At the end of September the sale value of HPUT units was £61,000 below the £1m cash sum paid.

1.2.15 The sale value of units in each fund has increased at a steady rate each month since they were acquired. Provided the economy / demand for commercial property continues at its current pace the sale value of units in each fund will exceed the cash sum paid sometime during next financial year (some 12 to 18 months from the start of each investment).

1.2.16 In setting the budget for the current financial year no income from property funds was anticipated. Based on recent performance and the timing of each property fund investment, £80,000 (4% return excluding capital appreciation) has been included in this year's revised estimates.

1.3 Annual Investment Strategy for 2018/19

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. A review in 2016 of the Council's cash balances identified the opportunity to invest up to £2m (circa 20% of expected long term balances) in a higher yield investment. The Council's treasury advisor supported diversification into property as an asset class. Whilst further property fund investment isn't feasible from existing balances the **2018/19 investment strategy includes scope to undertake additional property fund investment** from any 'new money' that may become available. This 'new money' is likely to be derived from the sale of existing property assets but may also arise from other 'windfalls' like the £0.5m funding attributable to the Kent Business Rates Retention pilot.

1.3.2 **Medium term investment**. Property investment is considered a long term commitment (10 years) and stems from the high entry and exit costs which need to be recouped and to mitigate the impact of a fall in commercial property values should the economy enter recession. Other investment opportunities are being explored that offer higher returns than our conventional term deposits with banks and building societies but aren't subject to the same time constraints as property. One such opportunity is investment in a diversified income (multi-asset) fund which typically implies a 5 year commitment.

1.3.3 Diversified income (multi-asset) funds are pooled vehicles investing in a broad range of asset classes including cash, bonds, property and equity. Risk is diversified via the spread of investments across the different asset classes and portfolios actively managed to reflect the changing economic environment. Funds typically achieve a return of 3% to 4% per annum and combine this with the potential for capital growth over time. Purchase and redemption of units is generally effected within 3 days. Buy / sell prices are subject to a spread, similar to property funds, but the spread is much lower are circa 1.5%. Dividends are paid quarterly and annual management fees range for 0.75% to 1.5% per annum.

1.3.4 The Council's treasury advisor, Link Asset Services, comment 'that where long term cash is concerned the diversification into multi-asset income funds is appropriate if the risk factors identified are acceptable to the Authority and due diligence is evidenced in the fund manager appointment process'.

1.3.5 As with the recent property fund selection process our treasury advisor would be engaged to assist with the detailed work required to ensure a suitable fund was selected that struck the right balance between risk and return. **The 2018/19 annual investment strategy allows up to £2m (circa 20% of expected long term balances) to be invested in a diversified Income (multi-asset) fund or funds**.

1.3.6 **Term deposit duration**. Link Asset Services provide a weekly credit update for all banks and building societies whom they deem suitable for local authority investment. That update includes a suggested investment duration. Since 2014 our annual investment strategies have allowed discretion to add 3 months to that suggested duration limit for UK institutions. In approving the 2017/18 investment strategy Members extended that discretion to plus 6 months subject to a number of constraints. Those constraints are: the extended duration is only used to take advantage of an exceptional offer; the standard exposure limit of 20% of funds per institution is reduced to 10% for any deposits in the extended (plus 6 months) duration; the institutions' CDS (credit default swop – market view of risk) at the time of placing the deposit must be below the average CDS for all institutions; and the overall duration of the deposit must not exceed 12 months.

1.3.7 Since taking back responsibility for the investment of all core funds from the Council's external fund manager in 2014, performance has always bettered the local authority average. In the quarterly benchmarking exercises undertaken last June and September (the latest two results available) the Council's performance was elevated to top quartile. Those same benchmarking exercise showed the risks (duration / credit quality) associated with our portfolio whilst slightly above the local authority average was not excessive by comparison. **The 2018/19 investment strategy replicates the plus 6 months duration discretion for UK institutions subject to the constraints detailed above**.

1.3.8 **Money market fund reform**. A press release (November 2016) announced the European Parliament, Commission and Council, after lengthy negotiation, had agreed regulatory changes to Money Market Funds (MMFs) operating in the European Union (which include 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 a AAA credit rated product and; ensure our peak monthly cash balances are distributed across a broad range of counterparties.

1.3.9 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 used 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. Some fund providers may opt to use existing VNAV (variable net asset value) funds as an alternative. Fund providers will need to comply with the regulatory changes during the second half of 2018. **The 2018/19 investment strategy allows LNAV and VNAV funds to be used as a substitute for our existing CNAV money market funds**.

1.3.10 **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 2018/19 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.

- In selecting suitable counterparties for overnight deposits and deposits up to 2 years in duration, the Council has adopted Link'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 Link's post CDS recommendation. For UK financial institutions Link's duration recommendation can be enhanced by up to six months subject to the combined duration (Link recommendation plus the enhancement) not exceeding 12 months. The Council's Treasury Management Practices have been 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 AAA rated and exposure limited to no more that 20% per fund. ***LNAV (low volatility) or VNAV (variable net asset value) funds may be used as an alternative to CNAV (constant net asset value) funds.***

- 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 20% (£2m) of expected long term cash balances.*** No limit applies where invested funds are derived from ***or in anticipation of*** new resources e.g. proceeds from selling existing property.

- ***Exposure to non-credit rated diversified income (multi-asset) funds is limited to no more than 20% (£2m) of expected long term cash balances***.

- 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 in property funds ***and diversified income funds***.

1.3.11 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.

1.3.12 The 2018/19 strategy **[Annex 4]** reflects the current economic environment, Link Asset Services' latest interest rate forecast and incorporates the risk parameters summarised in paragraph 1.3.10.

1.4 MiFID II.

1.4.1 The Financial Conduct Authority (FCA) implementation of the European Union's second Markets in Financial Instruments Directive (MiFID II) commenced on 3 January 2018. The directive impacts on the way local authorities access financial services provided by banks, advisors, brokers and fund managers.

1.4.2 Under MiFID II, all local authorities are by default classified as 'retail clients' i.e. the same as a private individual. Those authorities that meet certain quantitative and qualitative criteria are able to opt-up to professional status. Professional status is considered vital to ensure the Council is able maintain adequate market access to ensure diversification, liquidity and yield can continue to be managed effectively.

1.4.3 Thirteen opt-up applications were submitted (autumn 2017) to the Council's money market funds, property funds, brokers and some banks. I'm happy to report that thus far nine institutions have responded and all respondents have classified the Council's treasury operation as 'elective professional'.

1.5 Treasury and Prudential Codes of Practice

1.5.1 Updated Treasury Management and Prudential codes of practice were published by CIPFA on 21 December 2017. Whilst the codes apply to the 2018/19 financial year, given the timing of their release, CIPFA's Treasury and Capital Management Panel recommend the requirements of both Codes be 'implemented as soon as possible' and acknowledge that they may not be 'fully implemented until' the '2019/20 financial year'.

1.5.2 The Codes have been updated to address concerns arising from the Localism Act 2011 (commercialism agenda). The focus of both updates is to ensure the risks associated with investment in '**non-financial assets** which are held primarily for financial returns' are properly evaluated, reported, subject to scrutiny and managed over time. Non-financial assets will include the purchase of property to rent, shares and loans in subsidiaries or other outsourcing structures such as IT or building services providers.

1.5.3 The updated Codes will require amendment to the Council's Treasury Management Practices and Capital Strategy. Progress to ensure full compliance will be reported to Audit Committee during 2018.

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 the 2011 update. Any changes to ensure compliance with the Treasury Management and Prudential Codes of practice issued December 2017 will be put in place at the earliest opportunity.

1.7 Financial and Value for Money Considerations

1.7.1 Investment income from cash flow and core cash at the end of December 2017 (month nine of the financial year) is £63,900 better than budget for the same period. Additional income for the 2017/18 financial year as a whole of £70,000 has been incorporated in the revised estimates.

1.7.2 No provision was included in the current year budget for income from property funds. Reflecting the timing of those investments and based on recent performance, income of £80,000 has been incorporated in the revised estimates.

1.7.3 The Bank Rate having remained at a historic low of 0.5% for over seven years was cut to 0.25% in August 2016. In November 2017, the Bank of England returned the Bank Rate to 0.5%. The next rise in Bank Rate is not anticipated until the fourth quarter of 2018.

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

1.7.5 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. The duration of a property fund investment may need to be extended to avoid crystalizing a loss and as a consequence, duration cannot be determined with certainty.

1.7.6 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.

1.7.7 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.

1.8 Risk Assessment

1.8.1 Link Asset Services 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 2018/19 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 Cabinet:

1) note the treasury management position as at 31 December 2017 and the higher level of income incorporated in the 2017/18 revised estimates;

2) increase the Council's exposure to property funds in 2018/19 as additional long term funds become available e.g. from selling existing property;

3) endorse the limited use of diversified income funds for medium term investment;

4) adopts the Annual Investment Strategy for 2018/19 set out at **[Annex 4]**.

Background papers: contact: Mike Withey

Link Asset Services Interest Rate Forecast (November 2017) and Economic Commentary

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