

# TONBRIDGE & MALLING BOROUGH COUNCIL

## AUDIT COMMITTEE

03 April 2018

### Report of the Director of Finance and Transformation

#### Part 1- Public

#### Matters for Recommendation to Cabinet

#### 1 TREASURY MANAGEMENT UPDATE

**This report provides an update on treasury management activity undertaken during the 2017/18 financial year within the context of the national economy and invites Members to endorse the action taken by officers and note the treasury position at the end of February 2018.**

#### 1.1 Introduction

1.1.1 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 ensures the Council is embracing best practice in accordance with CIPFA's revised Code of Practice and subsequent updates.

#### 1.2 Economic Background

1.2.1 The UK economy grew by 1.8% in 2017, its slowest rate of annual growth since 2012. Survey data released in February points to growth continuing at a slightly slower pace in the first quarter of 2018. However, the Bank of England's forecast for GDP growth for the 2018 was increased to 1.8% (previously 1.6%) at their meeting in February.

1.2.2 The unemployment rate at 4.4% in the three months to December 2017 (up 0.1% on November) is low by historic norms. CPI continued above target at 3% in January (RPI 4%). The elevated level, driven primarily by the post referendum fall in the value of sterling, is expected to ease as the year unfolds. Whilst total earnings (including bonuses) rose by an annual rate of 2.8% in the three months to December, nominal pay growth which takes account of inflation is still in negative territory. The worst of the pay squeeze is expected to pass in the near future paving the way for a recovery in consumer spending.

1.2.3 At their February 2018 meeting, the Monetary Policy Committee voted unanimously to leave the Bank Rate unchanged at 0.5%. However, the Committee indicated 'rates would be increasing sooner and at a greater rate than

was previously thought'. Recent market data suggests a 70% chance of a Bank Rate rise in May.

- 1.2.4 Elsewhere, the Eurozone recoded annual growth in GDP of 2.5% in 2017 (highest since 2007) and the US 2.3%.

### 1.3 Interest Rate Forecast

- 1.3.1 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%. Link's current forecast (February 2018) anticipates the Bank Rate rising to 0.75% in June 2018 and to 1.0% in December 2018.

Rate	Now	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.50
3 mth LIBID	0.40	0.40	0.70	0.70	0.90	0.90	0.90	0.90	1.20	1.20	1.20	1.40
6 mth LIBID	0.50	0.50	0.80	0.80	1.00	1.00	1.00	1.10	1.30	1.30	1.40	1.50
12 mth LIBID	0.74	0.80	1.10	1.20	1.20	1.20	1.20	1.30	1.40	1.40	1.50	1.75
25yr PWLB	2.80	2.80	2.90	3.00	3.20	3.20	3.30	3.30	3.40	3.50	3.50	3.50

### 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 balances 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 £15m.
- 1.4.4 The Authority also has £18m 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 £4m (down from £8m at the start of the financial year) to meet business rate appeals which are expected to be resolved in 2018/19.

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

1.4.6 A full list of investments held on 28 February 2018 is provided at **[Annex 1]** and a copy of our lending list of 2 March 2018 is provided at **[Annex 2]**. The table below provides a summary of funds invested and interest earned at the end of February.

	<b>Funds invested at 28 Feb 2018 £m</b>	<b>Average duration to maturity Days</b>	<b>Weighted average rate of return %</b>	<b>Interest earned April to February 2018</b>	<b>Gross annualised return %</b>	<b>LIBID benchmark (average since 1 April 2017) %</b>
<b>Cash flow</b>	16.9	3	0.57	63,600	0.46	0.20 (7 Day)
<b>Core cash</b>	18.0	77	0.72	136,900	0.67	0.27 (3 Month)
<b>Sub-total</b>	<b>34.9</b>	<b>41</b>	<b>0.65</b>	<b>200,500</b>	<b>0.59</b>	<b>0.24 (Average)</b>
<b>Long term</b>	3.0			47,400	3.79	
<b>Total</b>	<b>37.9</b>					

*Interest on long term investments is based on dividends declared by the Local Authorities' Property Fund, the Lothbury Property Trust and the Hermes Property Unit Trust to the end of December 2017.*

1.4.7 **Cash flow and Core Cash investments.** Interest earned of £200,500 from cash flow surpluses and core cash balances to the end of February is £21,100 better than the revised estimate for the same period (£85,100 better when compared to the original 2017/18 estimate). The Authority also outperformed the LIBID benchmark by 35 basis points. The additional income is due primarily to the higher core cash balance attributed to business rate appeal provisions.

1.4.8 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 31 December 2017, the Council's return at 0.63% (purple diamond) was above the local authority average of 0.53% 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.

1.4.9 **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.

- 1.4.10 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 2017. The process culminated in three funds being selected for immediate investment.
- 1.4.11 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 been 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.
- 1.4.12 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.
- 1.4.13 Primary units in the Local Authorities' Property Fund (LAPF) and Lothbury Property Trust (LPT) were acquired at the end of June 2017 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 2017 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 2017 the sale value of HPUT units was £61,000 below the £1m cash sum paid.
- 1.4.14 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).

1.4.15 When the original budget for the current financial year was set (February 2017) no income from property funds was anticipated. Based on initial 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. Actual performance to the end of December was 3.79% and compares well with the revised estimate assumption.

## **1.5 Borrowing**

1.5.1 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 Treasury Management Strategy Statement. In this regard it is confirmed that no borrowing was undertaken in the period April 2017 to February 2018.

## **1.6 Compliance with the Annual Investment Strategy**

1.6.1 Throughout the period April 2017 to February 2018 the requirements set out in the 2017/18 Annual Investment Strategy which aim to limit the Council's exposure to investment risks (minimum counterparty credit criteria; sovereign, counter-party and group exposure limits; type of investment instrument; and investment duration limits) have been complied with.

## **1.7 Legal Implications**

1.7.1 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, Link Asset Services are employed to provide independent advice on legislative and professional changes that impact on the treasury management function.

## **1.8 Financial and Value for Money Considerations**

1.8.1 Investment income at the end of February 2018 (month eleven) from cash flow and core cash investments is £21,100 better than the revised budget for the same period. Income from property funds is broadly in-line with revised budget expectations.

1.8.2 The Bank Rate having remained at a historic low of 0.5% for over seven years was cut to 0.25% in August 2016. In November 2017, the Bank of England returned the Bank Rate to 0.5%. There is growing expectation that Bank Rate will be raised again summer 2018.

1.8.3 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.

- 1.8.4 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, the investment's duration cannot be determined with certainty.
- 1.8.5 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.
- 1.8.6 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.

## **1.9 Risk Assessment**

- 1.9.1 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.

## **1.10 Equality Impact Assessment**

- 1.10.1 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act.

## **1.11 Recommendations**

- 1.11.1 Members are invited to **recommend** that Cabinet:

- 1) endorse the action taken by officers in respect of treasury management activity for the period April 2017 to February 2018; and
- 2) note the treasury position at the end of February 2018.

Background papers:

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Nil

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