TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

23 July 2018

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2017/18

The report provides an update on treasury management activity undertaken during April to June of the current financial year. The treasury management outturn position for 2017/18 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 The UK economy grew by 1.8% in 2017, its slowest rate of annual growth since 2012. Growth in the first quarter (Q1) of 2018 at 0.2% also disappointed. This was driven in part by the unusually bad weather that affected all parts of the country. The weak growth has also been attributed to the fall in consumer disposable income as inflation has, until recently, outstripped wage growth. Early data and surveys released in July suggest stronger growth in Q2 2018 improving again in Q3 2018.

1.2.2 In contrast to GDP, the labour market has continued to show strength with the unemployment rate maintaining its downward trend falling to a multi-decade low in April of 4.2%. At the same time pay growth, excluding bonuses, rose by 2.8% in April with survey data suggesting that upward trend will continue through 2018. CPI inflation whilst still above target (2.0%) has fallen from a high of 3.1% in November 2017 to 2.4% in May 2018. Inflation is expected to come under pressure from rising oil / energy prices in the short term but fall back later in the year from easing food prices and other imported goods inflation as the impact of the post referendum fall in the value of sterling fades.

1.2.3 At their February meeting, the Monetary Policy Committee voted unanimously to leave Bank Rate unchanged at 0.5%. However, the committee indicated 'rates would be increasing sooner and at a greater rate than was previously thought'. This prompted market expectation rising to near 100% of a Bank Rate increase in May. The May meeting disappointed and the Bank's stance changed to a data dependent wait and see. The improving economic position and the split vote (6:3) at the June meeting has again led to growing market expectation of an early rate rise (70% expectation that this will take place in August).

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 (May 2018) anticipates the Bank Rate rising to 0.75% by December 2018 and to 1.0% by September 2019.

Rate	Now	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	**0.50**	**0.50**	**0.75**	**0.75**	**0.75**	**1.00**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**
3 mth LIBID	**0.60**	**0.70**	**0.90**	**0.90**	**0.90**	**1.10**	**1.20**	**1.30**	**1.40**	**1.50**	**1.60**	**1.60**
6 mth LIBID	**0.70**	**0.80**	**1.00**	**1.00**	**1.00**	**1.20**	**1.20**	**1.30**	**1.50**	**1.60**	**1.70**	**1.70**
12 mthLIBID	**0.80**	**0.90**	**1.10**	**1.10**	**1.20**	**1.30**	**1.40**	**1.40**	**1.60**	**1.70**	**1.80**	**1.80**
25yr PWLB	**2.70**	**2.80**	**2.90**	**3.00**	**3.10**	**3.20**	**3.30**	**3.30**	**3.40**	**3.40**	**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 **[Annex 1]**. Thus far in 2018/19 cash flow surpluses have averaged £8.8m.

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 £4m to meet business rate appeals which are expected to be resolved in 2018/19.

1.4.5 Long term investment at the end of June 2018 comprised £4m in property fund investments. A further £1m was invested in a property fund on 2 July 2018.

1.4.6 A full list of investments held on 30 June 2018 is provided at **[Annex 2]** and a copy of our lending list of 2 July 2018 is provided at **[Annex 3]**. The table below provides a summary of funds invested and interest / dividends earned at the end of June.

	Funds invested on 30 June 2018	**Average duration to maturity**	**Weighted average rate of return**	**Interest / dividends earned 1 April to 30 June 2018**	**Gross annualised return**	**LIBID benchmark (average from 1 April 2018)**
	£m	**Days**	**%**	**£**	**%**	**%**
Cash flow	9.1	2	0.52	10,950	0.50	0.36 (7 Day)
Core cash	22.0	178	0.86	44,600	0.78	0.56 (3 Mth)
Sub-total	**31.1**	**126**	**0.76**	**55,550**	**0.70**	**0.50 (Ave)**
Long term	4.0			30,900	3.74	
Total	35.1					

Dividends / return on long term investments is based on dividends declared by the Local Authorities' Property Fund and the Lothbury Property Trust and an estimated dividend for the Hermes Property Unit Trust (HPUT). HPUT's dividend for April to June will be declared mid-August.

1.4.7 **Cash flow and Core cash Investments**. Interest earned of £55,500 to the end of June is £10,300 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 20 basis points. The additional income is due in part to the higher core fund balances (unspent business rate appeals provisions) and in part due to an improvement in investment rates banks were offering in March and April in anticipation of a May rise in Bank Rate. Investment rates have since fallen back to post November 2017 Bank Rate rise levels.

1.4.8 The Council takes advantage of Link's benchmarking service 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 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 2018 our return at 0.67% (purple diamond) was above the local authority average of 0.61%. Based on the Council's exposure to credit / duration risk that return was also above Link's predicted return (above the upper boundary indicated by the green diagonal line). The Council's risk exposure was broadly in-line with the local authority average.

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 and reaffirmed in February 2018.

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 was applied in 2017/18 bringing the total investment in property funds in last financial year to £3m. Investment was spread across 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. However, secondary market activity is limited.

1.4.13 £1m in 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 is currently valued below the £1m cash sum paid to each manager by £36,500 (3.7%) for LAPF and £7,850 (0.8%) 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 June 2018 the sale value of HPUT units is £9,900 (1.0%) 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 the sale value of units in each fund will exceed the cash sum paid sometime during this financial year (some 12 to 18 months from the start of each investment).

1.4.15 More recently, a further £1m in primary units were acquired in the Local Authorities' Property Fund at the end of May 2018. At the end of June these units have a sale value below purchase price of £76,200 (7.6%). At the beginning of July a further £1m in units were also purchased in the Lothbury Property Trust. These units were acquired via the secondary market and generated a net saving against the standard entry price of £44,200 after deducting broker fees. The Lothbury units have a value if sold back to the fund manager of £27,000 (2.7%) below the £1m cash sum paid. These additional purchases are expected to be funded from the 2018/19 business rates pilot grant (£0.5m), the better than expected 2017/18 outturn (£0.5m) and (£1m) from sale proceeds associated with the River Walk Offices and Teen & Twenty site. Further investment in the Hermes Property Unit Trust is also envisaged later this financial year though purchase of units is dependent on progress being made with the property disposals mentioned above.

1.4.16 Thus far the property funds have recorded a return of 3.74% broadly in-line with our forecast return of 4%. Dividends to the end of June of £30,900 are £900 above profiled budget for the year. Performance against budget for the year as a whole will be influenced by the amount and timing of additional property fund investments.

1.5 Compliance with the Annual Investment Strategy

1.5.1 Throughout April to June 2018 all of the requirements contained in the 2018/19 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, May or June 2018.

1.5.2 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 October 2018 meeting of Audit Committee.

1.6 Bank Ring-fencing

1.6.1 Ring-fencing is one of a number of reforms to the banking sector introduced following the 2008 financial crisis. It affects the largest UK banks (banks with more than £25 billion in consumer and small business deposits) and requires them to create separate legal entities - a ring-fenced bank for their retail operations and a non-ring fenced bank for their investment banking activities.

Smaller banks and building societies are exempt. Ring fenced banks will be restricted in the investment services and products they can provide to their customers and in their credit exposure (lending) to other financial institutions and certain corporate customers. The ring-fencing requirement takes effect on 1st January 2019.

1.6.2 Banks which are expected to be impacted by the ring-fencing requirement include HSBC, Barclays, Lloyds (including Bank of Scotland), RBS (including National Westminster) and Santander and therefore applies to the majority of UK institutions on the Council's approved lending list. All banks affected are currently progressing the legal steps necessary to create the new entities. As the entities are created and named / renamed the credit rating agencies are ascribing credit ratings to them. Unless UK nationalised, the Council's lending list only comprises banks which have as a minimum: a high long term credit rating (i.e. Fitch A-) and; a very high short term credit rating (i.e. Fitch F1). New / renamed entities that fail to satisfy these criteria are automatically excluded from our lending list and are not eligible for investment.

1.6.3 An additional column has been added to the Council's lending list so that the status of a UK bank as "Ring-fenced", "Non-ring fenced (Non-RF)" or Exempt is recorded and can inform the investment decision making process. At the end of June 2018, no investments were held with entities that fail to meet the Council's minimum credit requirement, or through likely to fail to do so, as a consequence of the ring-fencing measures.

1.7 2017/18 Treasury Management Outturn

1.7.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 6 June 2018 as an annex to the Revenue and Capital Outturn report for 2017/18. 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.

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

2017/18 Financial Year	2017/18 Average Balance £m	Return %	2017/18 Interest / Dividends £	2017/18 Revised Estimate £	Variance Better (Worse) £
Cash flow surpluses	14.8	0.47	69,357	52,000	17,357
Core cash	21.9	0.67	147,722	144,000	3,722
Long term investment	2.0	3.73	74,643	80,000	(5,357)
		Total	291,722	276,000	15,722

1.7.3 The combined performance of the Authority's investments bettered the revised estimate by £15,722 (£165,722 when compared to the 2017/18 original estimates).

1.8 Legal Implications

1.8.1 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 are employed to provide independent advice on legislative and professional changes that impact on the treasury management function.

1.9 Financial and Value for Money Considerations

1.9.1 Investment income at the end of June 2018 (month three of the financial year) from cash flow surpluses and core cash investments is £10,300 better than budget for the same period. Income from property funds at the end of June is broadly in-line with budget expectations. Investment income for the 2017/18 financial year as a whole exceeded the revised budget by £15,722.

1.9.2 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%. Link's May 2018 forecast anticipates Bank Rate rising to 0.75% by December 2018.

1.9.3 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.

1.9.4 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.

1.9.5 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.

1.9.6 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.

1.10 Risk Assessment

1.10.1 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.

1.11 Equality Impact Assessment

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

1.12 Recommendations

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

1) Endorse the action taken by officers in respect of treasury management activity for April to June 2018.

2) Note the £5m in property fund investments that have been undertaken since June 2017.

3) Note the 2017/18 outturn position.

Background papers: contact: Mike Withey

Link interest rate forecast (May 2018)
Link benchmarking data (March 2018)

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