

Tonbridge and Malling Borough Council

Treasury Management Annual Report 2017/18

1.1 Introduction

1.1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activity and the actual prudential and treasury indicators for 2017/18. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.1.2 During 2017/18 the minimum reporting requirements were that full Council should receive the following reports:

- an annual treasury strategy in advance of the year;
- a mid-year treasury update; and
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, treasury management updates have been presented to each meeting of the Audit Committee throughout the 2017/18 financial year. Treasury performance was also considered at the Finance, Innovation and Property Advisory Board through the regular Financial Planning and Control reports.

1.1.3 Changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

1.1.4 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to full Council.

1.2 The Economy and Interest Rates

1.2.1 Bank of England forecasts following the June 2016 referendum anticipated a significant slowing of UK GDP growth. The Bank responded in August 2016 by cutting Bank Rate from 0.5% to 0.25% and making available over £100bn of cheap financing to the banking sector. Both measures were intended to stimulate growth in the economy. The forecasts now appear to have been overdone with the UK economy returning a G7 leading growth rate of 1.8% in 2016 followed by the same in 2017.

1.2.2 During 2017 there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth did weaken in the first half of 2017. The main reason for this was the sharp

increase in inflation caused by the devaluation of sterling after the referendum resulting in higher import costs. This caused a reduction in consumer disposable income as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weaker growth as consumers responded by reducing expenditure.

- 1.2.3 The September 2017 MPC meeting provided a shock to the markets with the tone in the minutes pointing to a Bank Rate increase in the near future. The November MPC quarterly Inflation Report meeting duly delivered withdrawing the 0.25% emergency rate cut implemented in 2016. The minutes from that meeting were viewed as dovish with little pressure to raise rates in the near term. In particular, GDP growth forecasts were again weak with little evidence of wage increase pressures despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching its 2% target as this was a one-off result of the devaluation of sterling following the referendum. The inflation forecast showed that the MPC expected inflation to come back to target (2%) over the next three years.
- 1.2.4 GDP growth in the second half of 2017 however came in stronger than expected and the start of 2018 saw evidence that wages were increasing at a faster pace. The February 2018 MPC meeting minutes revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift in their time horizon focusing on a two year time frame to manage inflation. This resulted in Markets anticipating a Bank Rate rise as early as May 2018.

1.3 Treasury Position at 31 March 2018

- 1.3.1 At the beginning and the end of 2017/18 the Council's debt and investment position was as follows:

	31 March 2017 £m	Rate / Return %	Average duration Days	31 March 2018 £m	Rate / Return %	Average duration Days
Variable rate debt:						
Overdraft	0.0	-	-	0.0	-	-
Total debt	0.0	-	-	0.0	-	-
Fixed rate investments:						
Cash flow surpluses	-	-	-	-	-	-
Core cash	17.0	0.69	118	13.0	0.80	118
Variable rate investments:						
Cash flow surpluses	6.1	0.50	61	6.4	0.47	3
Core cash	7.0	0.65	114	7.0	0.60	50
Sub-total	30.1	0.64	105	26.4	0.67	72
Long term investment						
Property Funds	-	-	-	3.0	3.73	-
Total investments	30.1	0.64	-	29.4	1.47	-

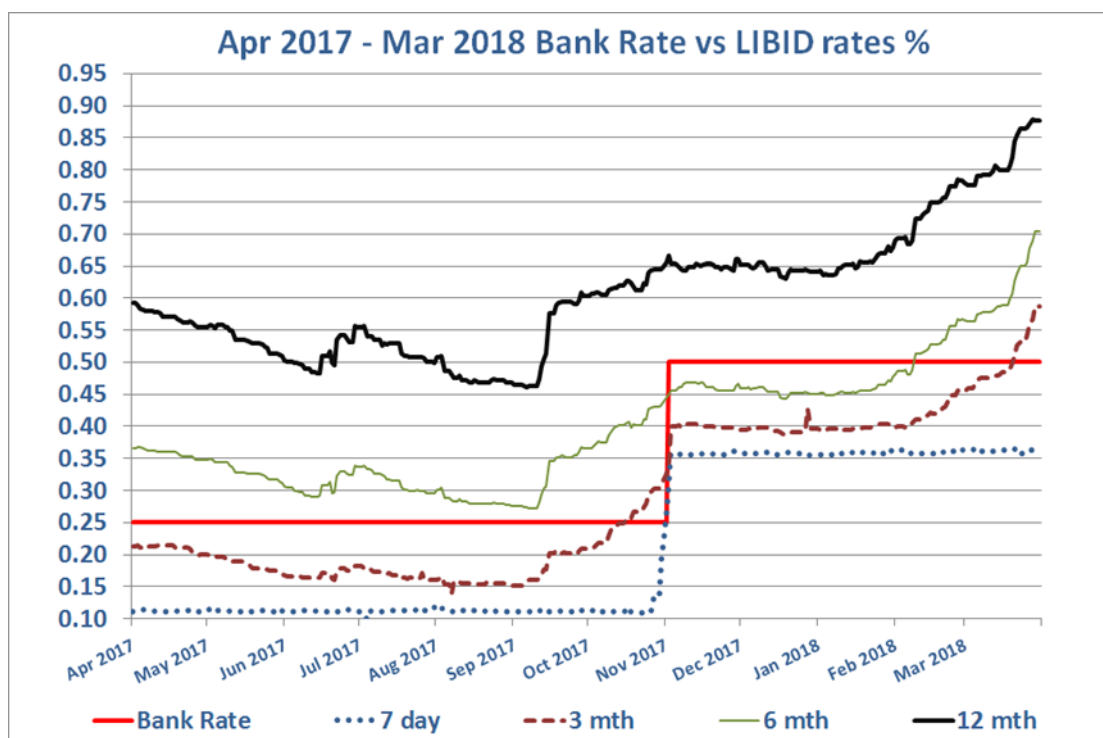
- 1.3.2 The modest fall in investment balances reflects use of the capital reserve (£1m) to finance capital expenditure offset by a rise in other reserves and balances reflecting savings against budget at outturn.

1.4 The Strategy for 2017/18

- 1.4.1 The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2, 2019 and then only increase once more before March 2020. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns.

1.5 Investment Rates in 2017/18

- 1.5.1 Rates offered by Banks for deposits continued at depressed levels at the start of 2017/18 due, in part, to a large tranche of cheap financing made available under the Bank of England's Term Funding Scheme. This facility ended in February 2018. Since mid-2017 investment rates for 3 months and longer began a rising trend in expectation of Bank Rate rising. Bank Rate was increased from 0.25% to 0.5% in November 2017. Further increases are expected over the next few years.



1.6 Investment Outturn for 2017/18

- 1.6.1 The Council's investment policy sets out the approach for choosing investment counter-parties and is based on credit ratings provided by the three main credit rating agencies. This is supplemented by additional market information including credit rating outlooks and credit default swap data (CDS). The

2017/18 Annual Investment Strategy was approved by Council in February 2017 and was subjected to a mid-year review in September 2017. In undertaking the review, no changes were made to the Council's minimum counter-party credit requirement (Fitch A-, F1 unless UK state owned) or counter-party exposure limits (maximum of 20% of funds for non-UK state owned financial institutions). Subject to a number of constraints, discretion to extend investment duration by up to six months over the Council's external treasury advisor's suggested duration was also retained.

- 1.6.2 **Cash flow investment.** In 2017/18 cash flow surpluses averaged £14.8m and earned an average rate of return of 0.47%. The average 7-day LIBID rate, used to compare performance, was 0.21%. Cash flow surpluses arise from the timing difference between the receipt of monies (from council tax, business rates, grants, etc.) and its subsequent payment (to precepting authorities, housing benefit recipients, suppliers, staff, etc.). Cash flow surpluses are required to meet regular payment obligations and as a consequence are invested in bank deposit accounts and money market funds which allow next day access. The opportunity to invest for longer durations and generate additional yield is taken when cash flow surpluses permit.
- 1.6.3 **Core cash investment.** In 2017/18 core cash averaged £21.9 and earned an average rate of return of 0.67%. The 3-month LIBID rate used as a comparator was 0.29%. Core cash comprises the authority's revenue and capital reserves. Unlike cash flow, core cash is not required to meet regular payment obligations and is available to invest for longer durations including durations exceeding one year. This added flexibility allows core cash to generate a better return relative to cash flow surpluses.
- 1.6.4 **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 commercial 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.
- 1.6.5 £2m of the Council's existing cash balances was identified for long term investment and 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 during 2017/18 to £3m. Additional property fund investments are expected over time as funds become available from asset disposals and other windfalls.
- 1.6.6 In 2017/18 investment in property funds averaged £2m and earned an average rate of return of 3.73% excluding capital appreciation. In addition to the income stream the underlying value of each property fund investment showed steady growth. Subject to economic performance, the sale value of units is expected to exceed the purchase price some time during the 2018/19 financial year.

1.6.7 **Summary.** Investment performance for the financial year as a whole is summarised in the table below:

	2017/18 Average Balance £m	Return %	2017/18 Interest/ Dividends Earned £	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

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

1.6.9 In finalising the Council's revised estimates, autumn 2017, the income estimate for cash flow was retained at its original level of £52,000, the return from core cash was increased from £74,000 to 144,000 and a new estimate to reflect income from property funds of £80,000 was introduced.

1.6.10 The significant increase in income from core cash reflected a combination of: higher than expected balances due to a delay by the Valuation Office in resolving outstanding business rate appeals; extending investment duration (higher proportion of 12 month deposits) and; managing cash flow and core cash balances in a more innovative way. Rather than opt for shorter duration cash flow investments as the financial year progressed (9 month investments at the start of the financial year, 6 months investments in the middle, 3 month investment towards the end) excess cash flow was transferred to core cash to take advantage of longer duration investments. Cash flow balances were then topped up towards the end of the financial year from available core cash maturities.

1.6.11 The improved performance for cash flow surpluses relative to the revised estimate (£69,357 actual vs £52,000 estimate) reflects the rapid improvement in money market fund returns following the Bank Rate rise November 2017.

1.7 Compliance with the Annual Investment Strategy

1.7.1 The Annual Investment Strategy aims to limit the Council's exposure to investment risks by prescribing: minimum counter-party credit criteria; maximum

exposure limits in respect of sovereigns, counter-parties and group of related counter-party; the type of investment instrument that can be used; and investment duration limits. Throughout the period April 2017 to March 2018 the requirements set out in the Annual Investment Strategy for 2017/18, as approved by Council in February 2017, were complied with. No liquidity issues were experienced resulting in nil borrowing throughout 2017/18.

1.8 MiFID II.

- 1.8.1 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.
- 1.8.2 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.
- 1.8.3 Thirteen opt-up applications were submitted (autumn 2017) to the Council's money market funds, property funds, brokers and some banks / building societies. In response, twelve institutions classified the Council's treasury operation as 'elective professional'. The thirteenth application was sent to a building society and has yet to be determined.

1.9 Treasury and Prudential Codes of Practice

- 1.9.1 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'.
- 1.9.2 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.
- 1.9.3 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.

Prudential and Treasury Indicators

1 Prudential Indicators	2016/17 Actual £'000	2017/18 Original £'000	2017/18 Actual £'000
Capital expenditure	1,632	3,128	1,834
Ratio of financing costs to net revenue stream	-2.33%	-1.10%	-2.46%
Net borrowing requirement:			
Brought forward 1 April	nil	nil	nil
Carried forward 31 March	nil	nil	nil
In year borrowing requirement	nil	nil	nil
Capital financing requirement as at 31 March	nil	nil	nil
Annual change in capital financing requirement	nil	nil	nil
Incremental impact of capital investment decisions:			
Increase in Council Tax (Band D) per annum	£0.10	£0.48	£0.48

2 Treasury Management Indicators	2016/17 Actual £'000	2017/18 Original £'000	2017/18 Actual £'000
Authorised limit for external debt:			
Borrowing	nil	5,000	nil
Other long term liabilities	nil	nil	nil
Total	nil	5,000	nil
Operational boundary for external debt:			
Borrowing	nil	2,000	nil
Other long term liabilities	nil	nil	nil
Total	nil	2,000	nil
Actual external debt	nil	nil	nil
Upper limit for fixed rate exposure over one year at year end	nil	0 – 60%	nil
Upper limit for variable rate exposure under one year at the year end	13,098 (43.5%)	40 – 100%	13,434 (45.6%)
Upper limit for total principal sums invested for over 364 days	nil (0%)	60%	3,000 (10.2%)

3 Maturity structure of new fixed rate borrowing during 2017/18	Upper limit %	Lower limit %
Under 12 months	100	nil
Over 12 months	nil	nil