TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

01 October 2018

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 August of the current financial year. A mid-year review of the Treasury Management and Annual Investment Strategy for 2018/19 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. The Code's revision in 2017 is the subject of a separate report on this agenda.

1.1.2 The primary requirements of the 2009 Code (and it's 2011 minor update) 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 2009 and 2011 Codes of Practice, and covers the following:

- An economic update and revised interest rate forecast.
- Investment performance for April to August of the 2018/19 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2018/19.
- Long term investment update.
- A review of the risk parameters contained in the 2018/19 Treasury Management and Annual Investment Strategy.

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 was also attributed to the fall in consumer disposable income as inflation has, until recently, outstripped wage growth. Growth improved in Q2 to 0.4% and Q3 got off to a good start helped by the warmer weather and World Cup.

1.2.2 The labour market has continued to show strength with the unemployment rate maintaining its downward trend falling to a multi-decade low in July of 4.0%. At the same time pay growth, excluding bonuses, rose by 2.9% in July outstripping inflation for the fourth consecutive month. CPI inflation whilst still above target (2.0%) has fallen from a high of 3.1% in November 2017 to 2.5% in July 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 2018 meeting, the Monetary Policy Committee (MPC) 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 again led to growing market expectation of an early rate rise. At the MPC's August meeting members voted unanimously to increase Bank Rate to 0.75%. The decision reaffirmed the Q1 dip in output was only temporary. In the subsequent press conference the rise was justified based on 'employment is at a record high, there is very limited spare capacity, real wages are picking up and external price pressures are declining'.

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 cut to 0.25% in August 2016. In November 2017, the Bank of England returned the Bank Rate to 0.5%. Bank Rate was increased to 0.75% in August 2018. Link's current forecast (August 2018) anticipates Bank Rate rising to 1.0% by September 2019 and to 1.25% by June 2020.

Rate	Now %	Dec-18 %	Mar-19 %	Jun-19 %	Sep-19 %	Dec-19 %	Mar-20 %	Jun-20 %	Sep-20 %	Dec-20 %	Mar-21 %
Bank Rate	**0.75**	**0.75**	**0.75**	**0.75**	**1.00**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**
3 mth LIBID	**0.75**	**0.80**	**0.80**	**0.90**	**1.10**	**1.10**	**1.20**	**1.40**	**1.50**	**1.60**	**1.60**
6 mth LIBID	**0.85**	**0.90**	**0.90**	**1.00**	**1.20**	**1.20**	**1.30**	**1.50**	**1.60**	**1.70**	**1.70**
12 mthLIBID	**1.00**	**1.00**	**1.00**	**1.10**	**1.30**	**1.30**	**1.40**	**1.60**	**1.70**	**1.80**	**1.80**
25yr PWLB	**2.80**	**2.90**	**3.00**	**3.10**	**3.10**	**3.20**	**3.30**	**3.30**	**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 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 2018/19 cash flow surpluses have averaged £11.3m.

1.4.4 The Authority also has £20m 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 and 2019/20.

1.4.5 Long term investment at the end of August 2018 comprised £5m in property fund investments.

1.4.6 A full list of investments held on 31 August 2018 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 / dividends earned at the end of August.

	Funds invested on 31 August 2018 £m	**Average duration to maturity Days**	**Weighted average rate of return %**	**Interest / dividends earned to 31 August 2018 £**	**Annualised return %**	**LIBID benchmark (average from 1 April 2018) %**
Cash flow	14.5	63	0.73	27,200	0.57	0.40 (7 Day)
Core cash	20.0	201	0.94	77,050	0.82	0.59 (3 Mth)
Sub-total	**34.5**	**143**	**0.85**	**104,250**	**0.74**	**0.53 (Ave)**
Long term	5.0			30,200	3.62	
Total	**39.5**					

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2018.

1.4.7 **Cash flow and Core cash Investments**. Interest earned of £104,250 to the end of August is £33,050 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 21 basis points. The additional income is due in part to higher core fund balances (unspent business rate appeals provisions) and in part due to an improvement in investment rates banks offered in the lead-up to and are now offering following the August Bank Rate rise.

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 3]**. The graph shows the return (vertical scale) vs. the credit / duration risk (horizontal scale) associated with an authority's investments. At 30 June 2018 our return at 0.76% (purple diamond) was above the local authority average of 0.66%. 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, including that derived from the sale of assets, was subsequently approved by Council in February 2017 and reaffirmed in February 2018.

1.4.10 £2m of the Council's existing cash balances was identified for long term investment. This in combination with £1m anticipated from the sale of surplus property was applied in 2017/18 bringing the total investment in property funds in that 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. More recently a further £2m has been invested in property funds. This has been financed from the 2018/19 business rates pilot grant (£0.5m), the better than expected 2017/18 outturn (£0.5m) and a further £1m in anticipated sale proceeds. Further investments are envisaged though timing will be dependent on the progress of planned disposals (River Walk Offices and Teen & Twenty site).

1.4.11 Property funds issue and redeem primary units at a buy and sell price with the difference between the two prices reflecting the costs associated with buying and selling 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. The following table compares the current sale value of each investment with the initial purchase price.

Property fund (Primary = units in the fund purchased from the fund manager, Secondary = units purchased from another investor at a discount, Date = first month investment attracted dividends)	**Purchase price** **(a)** **£**	**Sale value at date of purchase** **(b)** **£**	**Current sale value August 2018** **(c)** **£**	**Current sale value above (below) purchase price** **(c-a)** **£**
LAPF (Primary, July 2017)	1,000,000	922,200	964,400	(35,600)
Lothbury (Primary, July 2017)	1,000,000	927,700	997,300	(2,700)
Hermes (Secondary, October 2017)	1,000,000	939,000	997,900	(2,100)
LAPF (Primary, June 2018)	1,000,000	922,200	924,700	(75,300)
Lothbury (Secondary, July 2018)	1,000,000	973,000	978,100	(21,900)
Total	**5,000,000**	**4,684,100**	**4,862,400**	**(137,600)**

1.4.12 Income from property funds of £30,200 has been received thus far in 2018/19 (quarter ending June 2018) which represents an annualised return of 3.62%.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to August 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 ratings; duration 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 August 2018.

1.5.2 The Council has also operated within the treasury limits and prudential indicators set out in the 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.

1.6 Review of Risk Parameters

1.6.1 Members will recall the detailed consideration that was given to the 2018/19 Treasury Management and Annual Investment Strategy at the January 2018 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 high credit rated institutions and that those investments are diversified across a range of counterparties. More specifically the 2018/19 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 and 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 and groups of related counterparty must not exceed 20% of funds.

- In selecting suitable counterparties 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. 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 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. Where duration exceeds Link'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 (3 to 6 months) limited to 10% of funds.

- Money Market funds should be rated AAA and exposure limited to no more that 20% per fund. LNAV and VNAV funds may be used as a substitute for CNAV 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 each non-rated property fund used for long term investment is subject to a maximum £2m (20% of expected long term balances) per fund and across all such funds. No limit applies to new resources made available from, or in anticipation of, the sale of existing property assets or other windfalls.

- Each non-rated diversified income (multi-asset) fund used for medium term investment is subject to a maximum £2m (20% of expected long term balances) per fund and across all such funds.

- Non-specified investments over 1 year duration (includes both property funds and diversified income funds) must not exceed 60% of investment balances.

1.6.2 The returns being offered by financial institutions 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**.

1.7 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 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 from cash flow and core cash at the end of August 2018 (month five of the financial year) is £33,050 better than budget for the same period. Income for the 2018/19 financial year as a whole is likely to exceed budget by some £75,000.

1.8.2 Property funds are presently performing in-line with budget albeit just below the 4% target return. Budget performance for the year as a whole will in part be dependent on the timing of additional planned investments which have yet to take place and are themselves dependent on the receipt of sale proceeds from asset disposals.

1.8.3 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%. Bank rate was increased to 0.75% in August 2018. Link's current forecast (August 2018) anticipates Bank Rate rising to 1.0% by September 2019 and to 1.25% by June 2020.

1.8.4 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.

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

1.8.6 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.

1.8.7 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.

1.9 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 April to August 2018.

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

3) Retain the existing parameters intended to limit the Council's exposure to investment risks.

Background papers: contact: Mike Withey

Link interest rate forecast (August 2018)
Link benchmarking data (June 2018)

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