TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

21 January 2019

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 2019/20

The report provides details of investments undertaken and return achieved in the first nine months of the current financial year and an introduction to the 2019/20 Treasury Management and Annual Investment Strategy. Members are invited to recommend adoption of the Strategy to Cabinet.

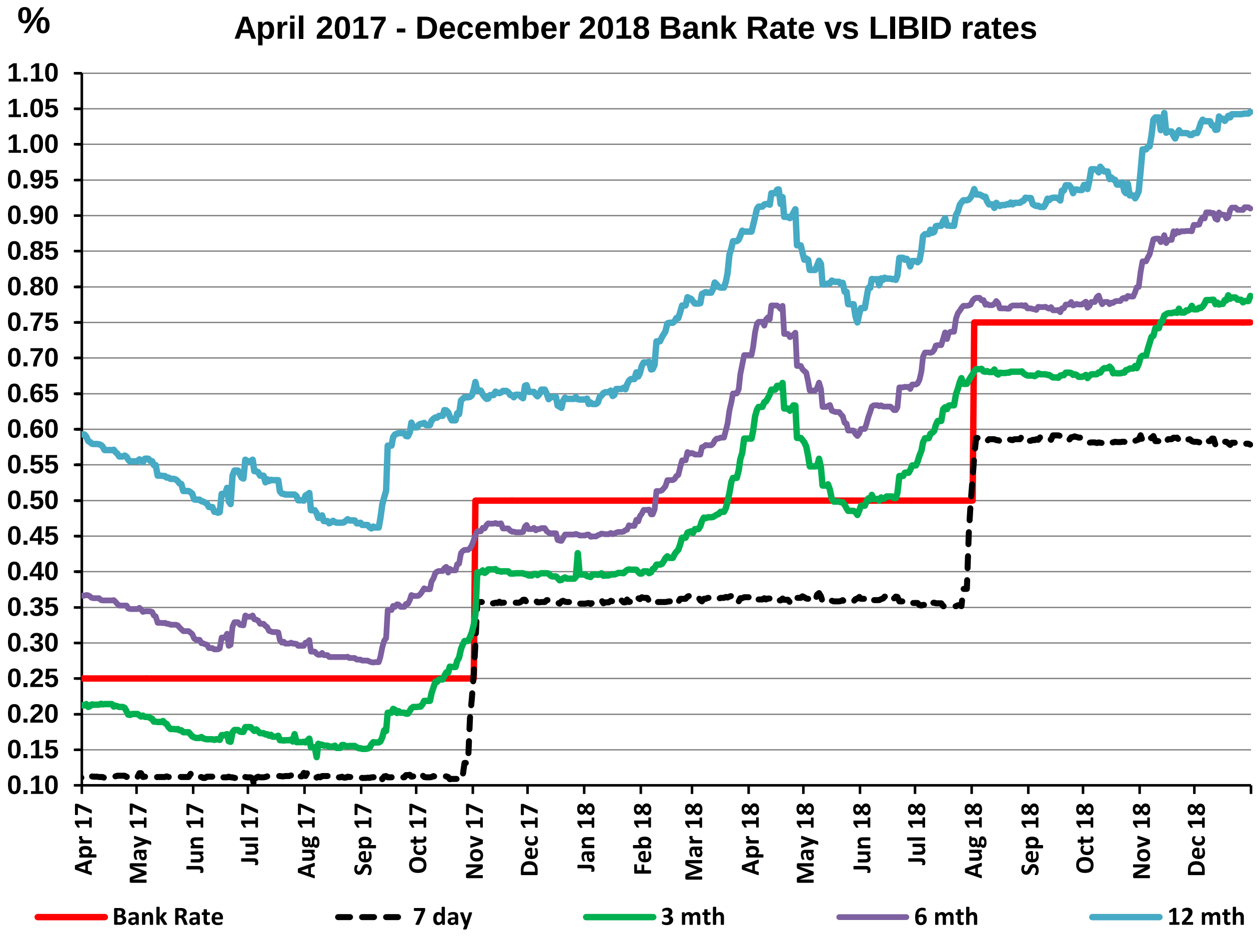
1.1 Introduction

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%. Bank Rate was increased to 0.75% in August 2018. Link's current forecast (November 2018), which assumes an orderly Brexit, anticipates Bank Rate rising to 1.0% by June 2019 and to 1.25% by March 2020. 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 2018/19 cash flow surpluses have averaged £14m.

1.2.4 The Authority also has £24m 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 to meet business rate appeals which are expected to be resolved during 2019/20 and beyond.

1.2.5 Long term investment comprises £5m in property fund investments.

1.2.6 A full list of investments held on 31 December 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 income earned at the end of December.

	Funds invested at 31 Dec 2018 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned to 31 Dec 2018 £	Annualised return %	LIBID benchmark (average from 1 April) %
Cash flow	18.7	29	0.83	75,400	0.70	0.48 (7 Day)
Core cash	24.0	144	0.97	149,200	0.88	0.65 (3 Mth)
Sub-total	**42.7**	**93**	**0.91**	**224,600**	**0.81**	**0.58 (Ave)**
Long term	5.0			118,050	3.54	
Total	47.7					

Property funds pay dividends quarterly. The return quoted above is based on dividends due April to December 2018.

1.2.7 **Cash flow and core cash investments**. Interest earned of £224,600 from cash flow surpluses and core cash balances to the end of December is £87,500 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 23 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. 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 £98,000 and this increase is reflected in the revised estimates.

1.2.8 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 September 2018 our return at 0.89% (purple diamond) was above the local authority average of 0.79%. 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.

1.2.9 **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.

1.2.10 £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), disposal proceeds from the Teen & Twenty site, Tonbridge (£0.75m) and a further £0.25m in anticipated sale proceeds. Further investments are envisaged though timing will be dependent on the progress of planned disposals (River Walk Offices).

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 December 2018** **(c)** **£**	**Current sale value above (below) purchase price** **(c-a)** **£**
LAPF (Primary, July 2017)	1,000,000	922,200	979,100	(20,900)
Lothbury (Primary, July 2017)	1,000,000	927,700	993,900	(6,100)
Hermes (Secondary, October 2017)	1,000,000	939,000	1,011,100	11,100
LAPF (Primary, June 2018)	1,000,000	922,200	938,800	(61,200)
Lothbury (Secondary, July 2018)	1,000,000	973,000	974,700	(25,300)
Total	**5,000,000**	**4,684,100**	**4,897,600**	**(102,400)**

1.2.11 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 table above compares the current sale value of each investment if sold to the fund manager with the initial purchase price.

1.2.12 Income from property funds of £118,050 is due thus far in 2018/19 (quarter ending December 2018) which represents an annualised return of 3.54%.

1.3 Annual Investment Strategy for 2019/20

1.3.1 **Long term balances**. Property fund investment was introduced in the 2017/18 investment strategy to mitigate the impact of the August 2017 bank rate cut (to 0.25%) and provided diversification into other asset classes. At that time the Council's long term balances were assessed at some £10m of which £2m (20%) was considered an appropriate amount to set aside for long term investment. That figure also matched the medium term financial strategy requirement that a minimum of £2m be retained in the General Revenue Reserve by the end of the 10 year strategy period providing some assurance over the availability of funds. Excluding proceeds from the sale of assets the Council's long term balances are currently expected to be some £15m. The 2019/20 investment strategy allows up to **£3m of existing resources to be invested in property funds**. £3m (20% of long term balances) may also be invested in diversified income funds used for medium term investment should that option be taken-up.

1.3.2 **UK sovereign rating**. The rating agencies have signalled that in the event of a disorderly Brexit the UK sovereign's current rating AA (very high) is likely to be downgraded. Whilst the Council doesn't usually invest in sovereign bonds it does use sovereign ratings as a starting point in its selection of appropriate financial institutions. The current strategy draws on those institutions who's sovereign is rated AA- or higher. The 2019/20 strategy maintains the minimum AA- requirement for all other sovereigns but introduces some flexibility by lowering the **minimum requirement for the UK to A-** (high).

1.3.3 **UK nationalised banks**. The economic consequences of a disorderly Brexit may also result in some UK centric financial institutions being downgraded. The current minimum credit requirement (Fitch long term A-, short term F1) is retained for all institutions including UK ones. The only exception in the 2019/20 investment strategy relates to **UK nationalised / part nationalised banks where a lesser requirement of Fitch BBB** (good), **F2** (good) **will be tolerated**.

1.3.4 **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 2019/20 Annual Investment Strategy **[Annex 4]** adopts the same risk parameters as currently approved. In summary these are :

- 100% of funds can be invested in the UK. Exposure to non-UK financial institutions is restricted to no more than 20% of funds per sovereign.

- Non-UK counterparties must be regulated by a sovereign rated AA- or higher as recognised by each of the three main rating agencies (Fitch, Moody's or Standard & Poor's).

- ***Investment in UK institutions is subject to the UK sovereign being rated A- or higher by each of the three main rating agencies.*** The UK's current rating is AA.

- 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, 1 year, 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). Other than for UK nationalised / part nationalised institutions this broadly equates to a minimum long term credit rating of Fitch A- (high) and a short term credit rating of Fitch F1 (highest).

- ***Investment in UK nationalised and part nationalised banks is subject to the bank having a minimum long term credit rating of Fitch BBB*** *(good)* ***and a short term credit rating of Fitch F2*** *(good).* The Royal Bank of Scotland and National Westminster Bank are currently rated Fitch A+, F1.

- 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 6 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 3 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 3 months for a UK institution) will be limited to 10% of ***investment balances****.*

- Money Market funds should be AAA rated and exposure limited to no more that 20% per fund. LVNAV (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% (***£3m***) 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% (***£3m***) 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.

1.3.5 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.

1.3.6 The 2019/20 strategy **[Annex 4]** reflects the current economic environment, Link Asset Services' latest interest rate forecast and incorporates the risk parameters summarised in paragraph 1.3.4.

1.4 Legal Implications

1.4.1 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.

1.4.2 This report fulfils the requirements of the Chartered Institute of Public Finance & Accountancy's Treasury Management and Prudential Codes of Practice 2017.

1.5 Financial and Value for Money Considerations

1.5.1 Investment income from cash flow and core cash at the end of December 2018 (month nine of the financial year) is £87,500 better than budget for the same period. Income for the 2018/19 financial year as a whole is likely to exceed budget by some £98,000.

1.5.2 Property funds are presently performing in-line with budget albeit just below the 4% target return. Income for the year as a whole is expected to be £172,000 some £23,000 below the original estimate for 2018/19. This reflects the delay in the disposal of surplus office accommodation at River Walk, Tonbridge.

1.5.3 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 (November 2018) anticipates Bank Rate rising to 1.0% by June 2019 and to 1.25% by March 2020.

1.5.4 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.

1.5.5 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.

1.5.6 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.

1.5.7 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.

1.5.8 Diversified income funds aim to limit risk by spreading investment across a broad range of asset classes (equities, bonds, property and cash). Nevertheless, the principal sum invested may fall as a consequence of adverse economic or market events.

1.6 Risk Assessment

1.6.1 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.

1.6.2 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.

1.6.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2019/20 Strategy have been minimised.

1.7 Equality Impact Assessment

1.7.1 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.

1.8 Recommendations

1.8.1 Members are invited to **RECOMMEND** that Cabinet:

1) Note the treasury management position as at 31 December 2018 and the higher level of income incorporated in the 2018/19 revised estimates;

2) Adopts the Treasury Management and Annual Investment Strategy for 2019/20 set out at **[Annex 4]**.

Background papers: contact: Mike Withey

Link Asset Services - Interest rate forecast (November 2018), economic commentary and benchmarking data.

Sharon Shelton
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