

TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

29 July 2019

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2018/19

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 2018/19 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 December 2017. The revised Code was adopted by Council on 30 October 2018 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.

1.2 Economic Background

1.2.1 The UK economy grew by 1.8% in 2018. Growth in quarter 1 of 2019 was unexpectedly strong at 0.5% (2.0% year on year). However, this was boosted by stock building ahead of the original March Brexit deadline. Growth in quarter 2 is expected to slow close to zero.

1.2.2 The Monetary Policy Committee raised Bank Rate from 0.5% to 0.75% in August 2018 but have since abstained from any further increases. Further action from the MPC is not expected until the uncertainties over Brexit clear. A no deal exit may see Bank Rate being cut in order to support growth. However, the MPC does have concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.5%, excluding bonuses, in the three months to December before falling marginally to 3.4% more recently. Growth in employment fell to only 32,000 in the three months to April, well below the 2018 average, while the unemployment rate remained at 3.8 percent, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

1.2.3 CPI inflation rose slightly to 2.1% in April before falling back again to 2.0% in May. Subject to an EU withdrawal agreement, CPI is expected to remain around this level over the next two years.

1.2.4 The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving. The difference between the two figures is now around 1.3% representing a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the UK in the coming months

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 (July 2019) anticipates Bank Rate rising to 1.0% by September 2020 and to 1.25% by March 2021.

Rate	Now	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.50
3 mth LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.20	1.30	1.40	1.40	1.40
6 mth LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.20	1.40	1.50	1.60	1.60	1.60
12 mth LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.80	1.80
25yr PWLB	2.40	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.00	3.10	3.20	3.30

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 £10.8m.

1.4.4 The Authority also has £26m 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 £8m to meet business rate appeals of which £3m are expected to be resolved in 2019/20 and the balance in future years.

1.4.5 Long term investment at the end of June 2019 comprised £5m in property fund investments.

1.4.6 A full list of investments held on 30 June 2019 is provided at **[Annex 2]** and a copy of our lending list of 1 July 2019 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 2019	Average duration to maturity	Weighted average rate of return	Interest / dividends earned 1 April to 30 June 2019	Gross annualised return	LIBID benchmark (average from 1 April 2019)
	£m	Days	%	£	%	%
Cash flow	8.4	44	0.80	20,600	0.76	0.57(7 Day)
Core cash	26.0	190	1.13	71,500	1.10	0.68 (3 Mth)
Sub-total	34.4	155	1.05	92,100	1.00	0.65 (Ave)
Long term	5.0			44,900	3.59	
Total	39.4			137,000	1.31	

1.4.7 **Cash flow and Core cash Investments.** Interest earned of £92,100 to the end of June is £21,500 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 35 basis points. The additional income is due to the higher core fund balances relating to unspent provisions for business rate appeals.

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 2019 the Council's return at 0.99% (purple diamond) was above the local authority average of 0.87%. Based on the Council's exposure to credit / duration risk that return was at the top-end of Link's predicted return (just below the upper boundary indicated by the green diagonal line). The Council's risk exposure was also 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 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.
- 1.4.10 £3m was invested in property investment funds during 2017/18 and a further £2m invested during 2018/19. Investment was spread across three funds to ensure, as far as is possible, stability of annual income and capital growth over time. Additional property fund investments are expected in the future as resources become available from asset disposals and other windfalls.
- 1.4.11 During the period 1 April 2019 to 30 June 2019 the £5m investment in property funds generated dividends (income) of £44,900 which represents an annualised return of 3.59%.
- 1.4.12 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 below compares the sale value of each investment if sold to the fund manager with the initial purchase price. Economic growth in the UK slowed in 2018/19 as did the rate at which fund sale values appreciated. A fall in sale values was recorded at some month ends especially during the second half of 2018/19. Nevertheless, since inception, the overall progress towards breakeven is still encouraging.

Property fund (Primary = units in the fund purchased from the fund manager. Secondary = units purchased from another investor at a discount. Date = first month the investment attracted dividends)	Purchase price (a) £	Sale value at date of purchase (b) £	Sale value 30 June 2019 (c) £	30 June sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	974,100	(25,900)
Lothbury (Primary, July 2017)	1,000,000	927,700	979,500	(20,500)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	1,010,100	10,100
LAPF (Primary, June 2018)	1,000,000	922,200	934,000	(66,000)
Lothbury (Secondary, July 2018)	1,000,000	973,000	960,600	(39,400)
Total	5,000,000	4,684,100	4,858,300	(141,700)

1.5 Compliance with the Annual Investment Strategy

- 1.5.1 Throughout April to June 2019 all of the requirements contained in the 2019/20 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 2019.
- 1.5.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The 2019/20 Prudential and Treasury Indicators will be included for review as part of the treasury management report to the October 2019 meeting of Audit Committee.

1.6 2018/19 Treasury Management Outturn

- 1.6.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 5 June 2019 as an annex to the Revenue and Capital Outturn report for 2018/19. 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.
- 1.6.2 A summary of the investment performance included in Annex 5 is as follows:

	2018/19 Average balance £m	Return %	2018/19 Interest/ dividends earned £	2018/19 Revised Estimate £	Variance Better (worse) £
Cash flow surpluses	15.5	0.73	112,189	90,000	22,189
Core cash	23.0	0.91	210,690	190,000	20,690
Long term investment	4.6	3.55	162,908	172,000	(9,092)
Total	43.1	1.13	485,787	452,000	33,787

- 1.6.3 The combined performance of the Authority's investments bettered the revised estimates by £33,787 (£108,787 when compared to the 2018/19 original estimates).

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 at the end of June 2019 (month three of the financial year) from cash flow surpluses and core cash investments is £21,500 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 2018/19 financial year as a whole exceeded the revised budget by £33,787.
- 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%. Link's July 2019 forecast anticipates Bank Rate rising to 1.00% by September 2020.
- 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 Council:

- 1) Endorse the action taken by officers in respect of treasury management activity for April to June 2019.
- 2) Note the 2018/19 outturn position.

Background papers:

contact: Mike Withey

Link interest rate forecast (July 2019)

Link benchmarking data (March 2019)

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