TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

16 June 2014

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2014/15

This report provides details of treasury management activity undertaken during April of the current financial year within the context of the national economy. The treasury management outturn position for 2013/14 is due to be reported to the June meeting of Cabinet and is also included in this report. Members are invited to endorse the action taken in respect of treasury management activity for April 2014 and note the outturn position for 2013/14.

1.1 Introduction

1.1.1 The Chartered Institute for 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 activities 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 Thus far in 2014/15:

- Economic recovery in the UK picked up momentum in the early months of 2014 with output growing by 0.8% in the first quarter of 2014 and by 3.1% for the twelve months to March 2014. Whilst the economy remains smaller than its 2008 pre-recession peak, output in the UK is expected to grow more strongly than any other Group of Seven (G7) economy this year.

- Inflation has exceeded the target (2%) set for the Bank of England (BoE) in every month for the four years December 2009 to December 2013. Since the turn of the year, the Consumer Price Index (CPI) has fallen to 1.6% for the 12 months to March 2014, easing the pressure on living standards. CPI is expected to remain at or below target over the next two years.

- The combination of rapidly rising house prices in London and the Southeast together with an improving outlook for the economy has led to recent media speculation of a Bank Rate rise as early as spring 2015. However, the quarterly inflation report published by the BoE in May provided a reminder that the economy "has only just begun to head back to normal". The expectation of low inflation, spare productive capacity and a desire to protect economic growth provides no impetus for the BoE to tighten monetary policy in the near term. Although distortions in the housing market pose a threat to the sustainability of the UK's economic recovery measures other than interest rates have proven more effective in controlling prices in the past.

- In the Eurozone, the UK's main trading partner, economic output for the bloc as a whole grew by only 0.1% in the first quarter of 2014. Recent activity surveys in the Eurozone continue to paint a picture of divergence between the pace of recovery in the major economies. While German data points to continued growth French figures dipped back into "contraction" territory. Weak growth couple with continuing concerns over deflation in the Eurozone has raised the expectation that the European Central Bank will need to intervene with further policy measures over the coming months.

- In the US the Federal Reserve has continued with is policy of tapering asset purchases with an expectation that this process will be completed this autumn. What happens after this will have a significant impact on markets in the second half of 2014. Whether the current accommodative policy remains or the economic situation supports further tightening of policy is open to question. Comment from the Chair, Janet Yellen, suggests the central bank will keep its "extraordinary" support for the economy for "some time to come".

1.3 Interest Rate Forecast

1.3.1 The Bank Rate has remained at an emergency level of 0.5% for the last 5 years. Capita's latest forecast, updated in May 2014, anticipates the Bank Rate will remain at this level for a further 18 months before rising in the final quarter of 2015.

Rate	Now	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
	%	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.25**	**1.50**
3 mth LIBID	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.60**	**0.70**	**0.80**	**0.90**	**1.00**	**1.20**	**1.50**
6 mth LIBID	**0.58**	**0.60**	**0.60**	**0.60**	**0.60**	**0.70**	**0.80**	**1.00**	**1.20**	**1.30**	**1.50**	**1.70**
12 mthLIBID	**0.80**	**0.80**	**0.80**	**0.80**	**0.90**	**1.10**	**1.20**	**1.40**	**1.60**	**1.70**	**1.90**	**2.10**
25yr PWLB	**4.16**	**4.30**	**4.40**	**4.50**	**4.60**	**4.70**	**4.80**	**4.80**	**4.90**	**4.90**	**5.00**	**5.00**

1.4 2014/15 Treasury Management Performance

1.4.1 The Annual Investment Strategy for the 2014/15 financial year was approved by Council on 18 February 2014. The Strategy, outlines the Council's investment priorities as follows:

- Security of Capital,
- Liquidity.

1.4.2 In addition the Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In particular, for 2014/15 the Council will “avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile ”. The Council has adopted Capita's recommended creditworthiness approach which incorporates the credit ratings from each of the three main rating agencies and includes sovereign credit ratings and a market view of risk using credit default swap (CDS) data.

1.4.3 A full list of investments held on 30 April 2014 and our internal lending list in operation on that date are shown in **[Annexes 1 and 2]** of this report.

1.4.4 As illustrated above, investment rates available in the market are at an historical low point. The average level of cash flow funds available for investment purposes to the end of April 2014 was £10.1m. These funds were available on a temporary basis and the amount mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The Authority holds £13.4m of core cash balances for investment purposes which are currently managed by an external fund manager. These funds are for the most part available to invest for more than one year, albeit some funds will need to be recalled towards the end of the financial year to top-up our daily cash balances.

1.4.5 As at the end of April 2014 funds invested and interest earned is set out in the table below:

	Funds invested at 30 April 2014 £m	**Average duration to maturity Yrs**	**Weighted average rate of return %**	**Interest earned to 30 April 2014 £**	**Gross annualised return to 30 April 2014 %**	**7 day LIBID benchmark %**
In-house cash flow	6.6	0.29	0.81	6,050	0.73	0.41
Externally managed core funds	13.4	0.80	0.59	7,100	0.64	0.41
Total	20.0	0.63	0.66	13,150	0.68	0.41

1.4.6 Interest earned of £13,150 is broadly in line with budget expectations (£300 higher than expected for cash flow and £850 lower for core funds) and 27 basis points better than benchmark.

1.4.7 **In-house Managed Cash Flow**. Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations. However, when cash surpluses permit, fixed term investments are undertaken to take advantage of the higher yields available. In mid-April the following fixed term investments were made:

£m	Bank / Building Society	Duration	Rate	Period
1.0	Bank of Scotland	12 Months	0.95%	11/4/14 – 13/4/15
1.0	Lloyds TSB	12 Months	0.95%	11/4/14 – 13/4/15

1.4.8 The current cash flow forecast **[Annex 3]** indicates limited potential for further fixed term investment in the second half of the financial year.

1.4.9 The Council takes advantage of Capita's benchmarking facility which enables us to gauge our in-house performance against Capita'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 2014 our return (purple diamond) was above the average for all other local authorities. Our return also outperformed that anticipated by the model based on our exposure to credit / duration risk.

1.4.10 **Externally Managed Core Funds**. In accordance with previous Investment Strategies all of the Council's core funds are currently managed by an external fund manager. Members are reminded that under the 2014/15 Strategy (considered by Audit Committee in January 2014) these funds are to be transferred to in-house management by the end of the financial year.

1.4.11 The core fund is being used to support both revenue and capital expenditure over the next few years of our medium term financial strategy as the authority grapples with savings targets to achieve a balanced budget. The core fund balance is currently £13.4m (expected to reduce to circa £11m by the end of the financial year) and is now at a level where in-house management is practical without the need for additional staff resources.

1.4.12 The transfer will contribute to savings targets through reduced fund management fees. Diversification of investment across a broad range of high quality counterparties will continue to be a key feature of our portfolio going forward and an element of liquidity within the core fund will be supported via the continued use of certificates of deposit.

1.4.13 Steps are currently being progressed to enable the transfer to take place over the summer.

1.5 Compliance with 2014/15 Annual Investment Strategy

1.5.1 During the financial year to date the Council has 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 2014 meeting of Audit Committee. No borrowing was undertaken during April 2014.

1.5.2 Throughout April 2014 all of the requirements contained in the 2014/15 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.

1.6 2013/14 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the last financial year is being submitted to Cabinet on 25 June 2014 as an annex to the Revenue and Capital Outturn report for 2013/14. That annex is replicated in full and provided at **[Annex 5]** to this report.

1.6.2 A summary of the investment performance included in **[Annex 5]** is as follows:

2013/14 Financial Year	**Average investment £m**	**Gross rate of return %**	**Interest earned £**	**Revised estimate £**
In-house managed cash flow (excluding Landsbanki)	10.9	0.69	75,150	72,000
Externally managed core funds	15.1	0.56	84,500	92,400
Total	26.0	0.61	159,650	164,400

1.6.3 Investment income of £159,650 is marginally below the 2013/14 revised estimate by £4,750. The gross return for the year of 0.61% exceeds the 7-day LIBID benchmark by 20 basis points. For year-end reporting purposes notional interest on our defaulted Landsbanki investment is added to the figures quoted above making total investment income for the year £179,800 (£15,400 higher than our revised estimate).

1.7 Legal Implications

1.7.1 The Council invested £1m in a three month fixed term deposit with the Icelandic bank, Landsbanki. The bank went into administration a few days prior to the investments intended maturity in October 2008. Members will be aware from reports to the Finance, Innovation and Property Advisory Board and Audit Committee of the Council's intention to sell its claim via a competitive process. The Council's claim was sold at an auction of claims held in late January and proceeds from the sale were received in early February 2014. The combination of partial payments and auction proceeds brought the total amount recovered to just over 95% of the original £1m investment.

1.7.2 The Council's participation in a joint action, co-ordinated by the Local Government Association, has ensured our legal costs have been minimised whilst allowing the Council to advance the strongest possible arguments to secure recovery. Participation in the auction has ensured the risks associated with pursuing full recovery (which would take many more years) have been avoided. Officers are satisfied that the price achieved at auction represents a good outcome for the Council.

1.8 Financial and Value for Money Considerations

1.8.1 The Bank Rate is expected to remain at the current historical low of 0.5% throughout the 2014/15 financial year. The Funding for Lending initiative introduced by the Bank of England in summer 2012 has had a significant downward impact on returns being offered by financial institutions. As a consequence, budgeted returns for 2013/14 were reduced at the January meeting Finance, Innovation and Property Advisory Board by £71,650 to £164,400. At year end, investment income including notional interest on our "defaulted" landsbanki investment was £15,400 higher than our revised estimate.

1.8.2 The perpetuation of a low Bank Rate (0.5%) and the impact of Funding for Lending were key features in our income projection for the 2014/15 financial year. Investment income earned to the end of April 2014 of £13,150 is broadly in-line with those expectations.

1.8.3 The performance of our fund manager is monitored against all of the players in the public sector cash management market place using data provided by Capita. In addition, the performances of both externally and internally managed investments are monitored against relevant benchmarks. The performance of the Council's in-house managed portfolio is also compared to other local authorities using benchmarking data provided by Capita.

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 the most effective way of mitigating the risks associated with treasury management.

1.10 Equality Impact Assessment

1.10.1 See 'Screening for equality impacts' table at end of report.

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 2014; and

2) Note the 2013/14 outturn position.

Background papers: contact: Mike Withey

Capita Interest Rate Forecast (May 2014)

Sharon Shelton
Director of Finance and Transformation

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
a. Does the decision being made or recommended through this paper have potential to cause adverse impact or discriminate against different groups in the community?	No	N/A
b. Does the decision being made or recommended through this paper make a positive contribution to promoting equality?	No	N/A
c. What steps are you taking to mitigate, reduce, avoid or minimise the impacts identified above?		N/A

In submitting this report, the Chief Officer doing so is confirming that they have given due regard to the equality impacts of the decision being considered, as noted in the table above.