TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

01 October 2019

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 2019/20 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 was revised December 2017 and adopted by this Council on 30 October 2018.

1.1.2 The primary requirements of the Code 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 Code and covers the following:

- An economic update and interest rate forecast.

- Investment performance for April to August of the 2019/20 financial year including recent benchmarking data.

- Compliance with Treasury and Prudential Limits for 2019/20.

- A review of the risk parameters contained in the 2019/20 Treasury Management and Annual Investment Strategy.

1.2 Economic Background

1.2.1 The first half of 2019/20 saw UK economic growth fall amidst continuing Brexit uncertainty and global growth concerns. In its August Inflation Report the Bank of England was notably downbeat about the outlook for both the UK and major world economies. This mirrored investor confidence around the world which is now expecting a significant downturn or possibly even a recession in some developed economies. Against this back drop it is no surprise that thus far in 2019 the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75%.

1.2.2 CPI inflation has been hovering around the Bank of England's target of 2% during 2019 (July 2.1%). The expectation is for CPI to move upwards a little over the rest of 2019/20 but not to a degree though likely to pose a concern for the MPC.

1.2.3 Despite the contraction in UK quarterly GDP growth of -0.2% q/q in quarter 2 (+1.2% y/y), employment rose by 115,000 in the same quarter. This suggests firms are preparing to expand output which could see a return to positive growth in quarter 3. Unemployment has continued close to a 44 year low of 3.9% in June. At the same time wage inflation picked up to a high of 3.9%. In real terms (after adjusting for the effects of inflation) earnings grew by 1.9%. As 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 coming months. The MPC views wage inflation in excess of 3% as an inflationary pressure which may warrant a rise in Bank Rate if Brexit is accompanied by a deal. A Bank Rate cut is thought likely in the event of a no deal Brexit.

1.2.4 Elsewhere, in response to slowing economic growth, the US Federal Reserve cut its equivalent of the Bank Rate by 0.25% in July 2019. The European Central Bank followed suit with a 0.1% cut in September 2019 and signalled a resumption of quantitative easing.

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 following the referendum on the UK's membership of the EU. 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 2019) anticipates Bank Rate rising to 1.0% by December 2020 and to 1.25% by March 2022.

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**	**0.75**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.25**
3 mth LIBID	**0.64**	**0.70**	**0.70**	**0.70**	**0.70**	**0.80**	**0.90**	**1.00**	**1.00**	**1.00**	**1.10**	**1.20**
6 mth LIBID	**0.67**	**0.80**	**0.80**	**0.80**	**0.80**	**0.90**	**1.00**	**1.10**	**1.10**	**1.20**	**1.30**	**1.40**
12 mthLIBID	**0.72**	**1.00**	**1.00**	**1.00**	**1.00**	**1.10**	**1.20**	**1.30**	**1.30**	**1.40**	**1.50**	**1.60**
25yr PWLB	**1.95**	**2.10**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.70**	**2.80**	**2.90**	**3.00**	**3.00**

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. Thus far in 2019/20 cash flow surpluses have averaged £13m.

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 August 2019 comprised £5m in property fund investments.

1.4.6 A full list of investments held on 31 August 2019 is provided at **[Annex 1]** and a copy of our lending list of 2 September 2019 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 2019 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 31 August 2019 £	Gross annualised return %	LIBID benchmark (average from 1 April 2019) %
Cash flow	14.3	42	0.81	42,200	0.78	0.57(7 Day)
Core cash	26.0	149	1.13	121,300	1.11	0.67 (3 Mth)
Sub-total	**40.3**	**111**	**1.01**	**163,500**	**1.00**	**0.64 (Ave)**
Long term	5.0			43,000	3.44	
Total	45.3			206,500	1.27	

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2019.

1.4.7 **Cash flow and Core cash Investments**. Interest earned of £163,500 to the end of August is £44,800 better than the original estimate for the same period. The authority also outperformed the LIBID benchmark by 36 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 3]**. The graph shows the return (vertical scale) vs. the credit / duration risk (horizontal scale) associated with an authority's investments. At 30 June 2019 the Council's return at 1.05% (purple diamond) was above the local authority average of 0.90%. Based on the Council's exposure to credit / duration risk that return also exceeded Link's predicted return (above 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 £43,000 which represents an annualised return of 3.44%.

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 and thus far in 2019/20. 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 31 August 2019 (c) £	31 August sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	965,900	(34,100)
Lothbury (Primary, July 2017)	1,000,000	927,700	984,000	(16,000)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	1,009,300	9,300
LAPF (Primary, June 2018)	1,000,000	922,200	926,100	(73,900)
Lothbury (Secondary, July 2018)	1,000,000	973,000	965,000	(35,000)
Total change in principal	5,000,000	4,684,100	4,850,300	**(149,700)**
			Total dividends received	**280,400**
			Net benefit	**130,700**

1.4.13 Since their inception, the Council has received dividends from its property fund investments totalling £280,400. Taking the current £149,700 deficit on sale values into account the net benefit to the Council thus far is £130,700.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to August 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 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 2019.

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 2019/20 Treasury Management and Annual Investment Strategy at the January 2019 meeting of 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 2019/20 Strategy requires:

- Counterparties must be regulated by a Sovereign rated AA- (UK minimum of A-) 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, 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. This broadly equates to a minimum long term credit rating of Fitch A- (high) and a short term credit rating of Fitch F1 (strong). A minimum of Fitch BBB (good), F2 (good) applies to UK nationalised / part nationalised banks.

- 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 £3m (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 £3m (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 2019 (month five of the financial year) is £44,800 better than budget for the same period. Subject to Bank Rate not falling below its current level this figure is expected to increase as the year progresses.

1.8.2 Property funds are presently performing in-line with budget albeit just below the 4% target return.

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 2019) anticipates Bank Rate rising to 1.0% by December 2020 and to 1.25% by March 2022.

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 2019.

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

Background papers: contact: Mike Withey

Link interest rate forecast (August 2019)
Link benchmarking data (June 2019)

Sharon Shelton
Director of Finance and Transformation