TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

27 July 2020

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2019/20

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 2019/20 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 In the UK 2020 started with optimistic business surveys pointing to an upswing in economic **growth** following the general election in December which settled the Brexit issue. Since then, the whole world has changed as a result of the coronavirus outbreak. The overall growth rate in quarter 1 was -2.2% (-1.7% y/y). However, the main fall in growth did not occur until April when it came in at -24.5% y/y after whole sections of the economy were closed down to limit the spread of the virus. Going forward there is uncertainty over the extent of the damage that will have been done to businesses, how consumer confidence and behaviour has been impacted, whether there could be a second wave of the outbreak, how soon a vaccine will be created and then how quickly it can be administered to the population. This leaves huge uncertainties as to how quickly the economy will recover to what was formerly regarded as normality.

1.2.2 The Monetary Policy Committee (MPC) left **Bank Rate** unchanged at 0.75% in January 2020. The onset of the coronavirus epidemic in March forced the MPC to make two emergency cuts in Bank Rate first to 0.25% and then to 0.10%. These cuts were accompanied by an increase in quantitative easing (QE - purchase of gilts by the Bank of England) of £200bn to maintain liquidity in financial markets. In June, the MPC added a further £100bn of QE purchases of gilts raising the total stock of QE purchases to £745bn. It is not currently thought likely that the MPC would go as far as to cut Bank Rate into negative territory, although the Governor of the Bank of England has said all policy measures will be considered. The Governor also recently commented about an eventual tightening in monetary policy – namely that he favours unwinding QE before raising interest rates. This has prompted some forecaster to suggest Bank Rate will remain low for a number of years.

1.2.3 To avoid people losing their **jobs** during the lockdown period the Government introduced various schemes to subsidise both employed and self-employed jobs. Government also put in place a raft of other measures to help businesses access loans from their banks. Despite these measure the Bank of England expects the unemployment rate to increase from 4% in January to 8% over the coming months.

1.2.4 The Government measures to support jobs and businesses will result in a substantial increase in the annual budget deficit for the current year, from about 2% to nearly 17% of national income. The ratio of **debt** to GDP is also expected to increase from 80% to around 105% of GDP. In the March Budget Government also announced increases in infrastructure spending to aid economic recovery. Economic statistics during June pointed to a rapid recovery. However, it may be a considerable time before activity recovers to its previous level.

1.2.5 The annual CPI **inflation** rate dropped to 0.5% in May from 1.8% in January and could reach zero by the end of the year. Inflation rising over 2% is unlikely to be an issue for the MPC over the next two years as the world economy is expected to succumb to recession. The early months of 2020 saw a sharp fall in oil prices. Other UK domestic prices will also be under downward pressure; wage inflation already on a downward path over the last six months is likely to continue that trend in the current environment where unemployment will be rising significantly. In May's Monetary Policy Report, the Bank of England predicted that inflation would be below their 2% target until 2022. This was in the context of their forecast that GDP would recover during 2021 and rise by 3% in 2022.

1.3 Interest Rate Forecast

1.3.1 Following the financial crisis in 2008, Bank Rate was cut to an emergency level of 0.5% where it remained for over seven years. The outcome of the 2016 EU referendum prompted Bank Rate to be cut to 0.25% in August 2016. Since then Bank Rate has risen in 0.25% steps, peaking at 0.75% from August 2018. Link's forecast used in the 2020/21 investment strategy assumed economic conditions would continue to improve requiring a gradual rise in Bank Rate over the next three years.

Link - Nov 2019	June-20 %	Sep-20 %	Dec-20 %	Mar-21 %	Jun-21 %	Sep-21 %	Dec-21 %	Mar-22 %	Jun-22 %	Sep-22 %	Dec-22 %	Mar-23 %
Bank Rate	**0.75**	**0.75**	**0.75**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**
3 mth LIBID	**0.70**	**0.80**	**0.90**	**1.00**	**1.00**	**1.00**	**1.10**	**1.20**	**1.30**	**1.30**	**1.30**	**1.30**
6 mth LIBID	**0.80**	**0.90**	**1.00**	**1.10**	**1.10**	**1.20**	**1.30**	**1.40**	**1.50**	**1.50**	**1.50**	**1.50**
12 mthLIBID	**1.00**	**1.10**	**1.20**	**1.30**	**1.30**	**1.40**	**1.50**	**1.60**	**1.70**	**1.70**	**1.70**	**1.70**
25yr PWLB	**3.40**	**3.40**	**3.50**	**3.60**	**3.60**	**3.60**	**3.70**	**3.80**	**3.90**	**3.90**	**4.00**	**4.00**

1.3.2 The world has changed since the 2020/21 strategy was publish in February 2020. Interest rate forecasting is now much more problematic and tentative than it is in normal circumstances. The scale of both Government and Central Bank intervention in recent months is historic in magnitude. Most governments have implemented lockdowns to limit the spread of Covid-19. Whilst lockdown measures are now being relaxed the full extent of the economic impacts is still uncertain.

1.3.3 Link updated their forecast in July 2020 as follows:

Link – July 2020	June-20 %	Sep-20 %	Dec-20 %	Mar-21 %	Jun-21 %	Sep-21 %	Dec-21 %	Mar-22 %	Jun-22 %	Sep-22 %	Dec-22 %	Mar-23 %
Bank Rate	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
3 mth LIBID	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**-**	**-**	**-**	**-**
6 mth LIBID	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**-**	**-**	**-**	**-**
12 mthLIBID	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**-**	**-**	**-**	**-**
25yr PWLB	**2.50**	**2.50**	**2.50**	**2.60**	**2.60**	**2.60**	**2.60**	**2.60**	**2.70**	**2.70**	**2.70**	**2.70**

1.3.4 The forecast is based on the assumption that Covid-19 will be defeated in the UK over the next six to twelve months through localised lockdowns and or the use of a vaccine. In addition:

- On-going market volatility may necessitate further Government and Central Bank intervention.
- MPC will aim for very loose monetary policy, primarily through the use of quantitative easing, in order to maintain low yields and funding costs to help support businesses and to maintain appropriate levels of liquidity.
- The result is expected to be a very flat yield curve for at least a year and only marginal increases over the following year.
- Bank Rate will stay at 0.1% for the next two years.
- Inflation is likely to be well below 2% and wage increases will be limited in the face of economic uncertainty coupled with a steady rise in unemployment.

- The economy is likely to take a considerable time to recover lost momentum.
- There will be a recession in world growth in 2020; growth is unlikely to recover quickly.

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 2020/21 cash flow surpluses have averaged £29m.

1.4.4 The Authority also has £13m 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.

1.4.5 Cash flow and core cash balances also include some £10m to meet business rate appeals of which £3m are expected to be resolved in 2020/21 and the remainder in future years.

1.4.6 Long term investment at the end of June 2020 comprised £5m in property fund investments.

1.4.7 A full list of investments held on 30 June 2020 is provided at **[Annex 1]** and a copy of our lending list of 29 June 2020 is provided at **[Annex 2]**. The table below provides a summary of funds invested and interest / dividends earned at the end of June.

	Funds invested on 30 June 2020 £m	Weighted average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 30 June 2020 £	Annualised weighted rate of return	LIBID benchmark (average from 1 April 2020) %
Cash flow	28.0	4	0.22	21,200	0.29	-0.05 (7 Day)
Core cash	13.0	153	0.55	31,200	0.78	0.26 (3 Mth)
Sub-total	**41.0**	**51**	**0.33**	**52,400**	**0.46**	**0.06 (Ave)**
Long term	5.0		3.45	35,800	2.87	
Total	46.0		0.67	88,200	0.70	

1.4.8 **Cash flow and Core cash Investments**. Whilst the authority outperformed the LIBID benchmark by 40 basis points, Interest earned of £52,400 to the end of June is £25,950 below the original estimate for the same period. The fall in income is due to the impact the emergency cuts in Bank Rate in March 2020 have had on investment opportunities. During March 2020 Bank Rate fell from 0.75% to 0.1%.

1.4.9 If bank offers remain at their current ultra-low levels throughout 2020/21 cash flow and core cash investment is likely to underperform against budget for the year as a whole by some £182,000. Opportunities to mitigate some of that impact will be explored with the Council's Treasury Advisor and reported to Audit Committee in October 2020. Impacts in 2021/22 and beyond will be addressed through updates to the Council's Medium Term Financial Strategy and in next financial years Annual Investment Strategy (due to be reported to Audit Committee in January 2021).

1.4.10 Members will be aware from the media in general and committee reports (Cabinet, FIPAB amongst others) of the pressures that the pandemic has and is having on the Council's finances. To ensure sufficient liquidity to meet payment obligations all core fund maturities arising in February, March and April were transferred to cash flow balances rather than being reinvested in new fixed term deposits. Following that action no payment issues arose and none are expected to during the remainder the 2020 calendar year. There remains a question mark over the proportion of council tax and business rates which will be collected in 2020/21. The lion's share of that collection is being paid to government and precept authorities spread over twelve monthly instalments. The current payment schedules predate Covid-19.

1.4.11 The recession is born out of a health crisis not a financial crisis. Whilst the UK sovereign credit rating has been downgraded from AA to AA- by Fitch, individual UK bank long-term and short-term credit ratings, for those banks on the Council's lending list, have not thus far been downgraded by the credit rating agencies. Whilst there have been a number of changes to rating watch and outlooks these have not resulted in a reduction in the investment duration assessment provided by Link (i.e. banks considered good for 12 month investment last January carry the same assessment today). Credit default swop data (CDS – a measure of risk) remains substantially below the levels noted during the sovereign debt crisis of 2012.

1.4.12 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. As at 31 March 2020 the Council's return at 0.69% (purple diamond) compared well with the local authority average of 0.71%. Based on the Council's exposure to credit / duration risk that return was in-line with Link's predicted return (between the upper and lower boundary indicated by the diagonal lines). The Council's risk exposure was also consistent with the local authority average.

1.4.13 **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.

1.4.14 £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.

1.4.15 During the period 1 April 2020 to 30 June 2020 the £5m investment in property funds generated dividends (income) of £35,800 which represents an annualised return of 2.87% (3.48% in 2019/20). Covid-19 has resulted in a proportion of rents due to be collected in June being deferred. These deferred rents are expected to be collected at some point during the current financial year. However, income from property funds is expected to underperform against budget by some £55,000 for the financial year as a whole. The majority of this figure relates to anticipated delays in the disposal of River Walk offices rather than being attributed to Covid-19.

1.4.16 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.

1.4.17 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 throughout 2019/20. More recently, the Covid-19 impact on the economy is expected to see commercial property values continue to decline in 2020/21 before commencing a recovery in 2021/22.

1.4.18 Although each property is unique, its value is informed by the sale of similar properties. During recession property transaction volumes diminish making valuation less certain. Each of our property fund managers have attributed “uncertainty” to their most recent monthly valuations. At the same time, and by regulation, when valuation is uncertain fund managers are required to suspend the purchase and redemption units by investors. The suspension is intended to protect the interests of purchasers, sellers and continuing investors such as ourselves and is welcomed.

1.4.19 Current qualified sale values vs initial purchase price are as follows:

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 2020 C £	30 June 20 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	901,200	(98,800)
Lothbury (Primary, July 2017)	1,000,000	927,700	916,900	(83,100)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	964,400	(35,600)
LAPF (Primary, June 2018)	1,000,000	922,200	864,050	(135,950)
Lothbury (Secondary, July 2018)	1,000,000	973,000	899,200	(100,800)
Total change in principal	5,000,000	4,684,100	4,545,750	**(454,250)**
			Total dividends received	**448,450**
			Net loss since inception	**5,800**

1.4.20 Since inception, the Council has received dividends from its property fund investments totalling £448,450. Taking the current £454,250 deficit on sale values into account the net loss to the Council is £5,800 (was a net gain of £173,800 to the end of December 2019). Fund values have fallen £258,300 in the six months to June 2020 due to the Covid-19 impact on the economy and commercial property values. The deficit in sales value is expected to be recouped overtime as the economy recovers.

1.4.21 Members are reminded that higher yielding investments (e.g. property, equities) have the potential to fluctuate in value, both up and down. It is this feature which makes them unsuitable for short term investment where certainty over value at maturity is a key criteria. The Council’s property fund investments are not required to meet day to day spending commitments and will only be realised should a higher yielding opportunity be identified.

1.5 Compliance with the Annual Investment Strategy

1.5.1 Throughout April to June 2020 all of the requirements contained in the 2020/21 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 2020.

1.5.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The 2020/21 Prudential and Treasury Indicators will be included for review as part of the treasury management report to the October 2020 meeting of Audit Committee.

1.6 2019/20 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 3 June 2020 as an annex to the Revenue and Capital Outturn report for 2019/20. That annex is replicated in full and provided at **[Annex 4]** 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 4 is as follows:

	2019/20 Average balance £m	Return %	2019/20 Interest/ dividends earned £	2019/20 Revised Estimate £	Variance Better (worse) £
Cash flow surpluses	19.9	0.76	150,734	125,000	25,734
Core cash	25.1	1.10	275,447	275,000	447
Long term investment	5.0	3.48	173,977	175,000	(1,023)
Total	50.0	1.20	600,158	452,000	25,158

1.6.3 The combined performance of the Authority's investments exceeded the revised estimate by £25,158 and by £117,158 when compared to the 2019/20 original estimate.

1.6.4 Income and expenditure attributed to the Treasury Management function for 2019/20 is provided at **[Annex 5]**. This shows the aggregate staff resource applied to treasury management is less than one full time equivalent and that income exceeds costs by a significant margin. Income in future years forms part of the Council's medium term financial strategy and is subject to changes in the level of reserves and changes in Bank Rate. Expenditure in future years is expected to rise in-line with inflation.

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 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 (BoE) returned the Bank Rate to 0.5%. Bank rate was increased to 0.75% in August 2018. In response to the anticipated impact of Covid-19 on the economy, BoE cut Bank Rate to 0.1% in March 2020. Link's current forecast (July 2020) anticipates Bank Rate remaining at 0.1% for at least the next two years.

1.8.2 Following the March 2020 cuts in Bank Rate investment income at the end of June 2020 (month three of the financial year) from cash flow surpluses and core cash investments is £25,950 below budget for the same period. Income from property funds at the end of June is below budget by £9,200. Investment income for the year as a whole is expected to underperform against budget by some £237,000.

1.8.3 Investment income for the 2019/20 financial year as a whole exceeded the revised estimate by £25,158 and the original estimate by £117,158.

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 twelve 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 2020.

2) Note the 2019/20 outturn position.

Background papers: contact: Mike Withey

Link interest rate forecast (July 2020)
Link benchmarking data (March 2020)

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