TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

28 September 2020

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 2020/21 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 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 the Code and covers the following:

- An economic update and interest rate forecast.

- Investment performance for April to August of the 2020/21 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2020/21.
- A review of the risk parameters contained in the 2020/21 Treasury Management and Annual Investment Strategy.

1.2 Economic Background

1.2.1 As expected, the Bank of England's Monetary Policy Committee (MPC) kept Bank Rate unchanged at their meeting on 6 August at 0.1%. The MPC also maintained the level of quantitative easing (QE) at £745bn. The Bank's forecasts were adjusted in three key areas:

- The fall in GDP in the first half of 2020 was revised down from 28% to 23%. This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to lockdown.
- The peak in the unemployment rate was revised down from 9% to 7.5% in the seconds half of 2020.
- The Bank anticipates there will be excess demand in the economy towards the end of 2022 causing CPI inflation to rise above the 2% target and remain above target in 2023.

1.2.2 The MPC also dismissed the use of negative interest rates, at least in the short term, suggesting that while negative rates can work in some circumstances it would be "less effective as a tool to stimulate the economy" at this time when banks have concerns about future loan losses. The MPC also has "other instruments available", including QE and the use of forward guidance.

1.2.3 The MPC still expects the £300bn of QE purchases announced between its March and June meetings to continue until the "turn of the year".

1.2.4 Whilst the economy is recovering better than previously forecast by the Bank, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to downside risks, which were judged to persist both in the short and medium term including the potential for a second wave of the virus. However, rather than a national lockdown, as in March, any spikes in virus infections are now expected to be addressed through localised measures which should limit economic impacts. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down in the furlough scheme through to the end of October is another development that could cause the Bank to review the need for additional support later in the year. Recovery is also expected to be more prolonged than the rapid V shape initially anticipated and longer term adjustment in areas like office space and travel which may take a number of years to recover to their pre lockdown levels. There is also likely to be a reversal of globalisation as the pandemic has shown how vulnerable long-distance supply chains are. Digital services, however, is one area that has seen significant growth.

1.2.5 One key addition to forward guidance was a new phrase in the policy statement, namely that the Bank "does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably". Given the expectations for inflation, some economist conclude that the current ultra-low Bank Rate will remain in place for a number years.

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	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**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**
3 mth LIBID	**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	**0.90**	**1.00**	**1.10**	**1.10**	**1.20**	**1.30**	**1.40**	**1.50**	**1.50**	**1.50**	**1.50**
12 mthLIBID	**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**	**3.50**	**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 published last February. 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 August 2020 as follows:

Rate	Sep-20 %	Dec-20 %	Mar-21 %	Jun-21 %	Sep-21 %	Dec-21 %	Mar-22 %	Jun-22 %	Sep-22 %	Dec-23 %	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**
3 mth LIBID	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**-**	**-**	**-**	**-**
6 mth LIBID	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**-**	**-**	**-**	**-**
12 mthLIBID	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**-**	**-**	**-**	**-**
25yr PWLB	**2.50**	**2.50**	**2.50**	**2.50**	**2.60**	**2.60**	**2.60**	**2.70**	**2.70**	**2.70**	**2.00**

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 below 2% throughout 2020 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 £18m 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 August 2020 comprised £5m in property fund investments.

1.4.7 A full list of investments held on 31 August 2020 is provided at **[Annex 1]** and a copy of our lending list of 1 September 2020 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 2020 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 31 August 2020 £	Gross annualised return %	LIBID benchmark (average 1 April to 31 August 2020)
Cash flow	22.2	8	0.11	28,000	0.23	-0.05(7 Day)
Core cash	18.0	186	0.47	44,600	0.66	0.14 (3 Mth)
Sub-total	**40.2**	**88**	**0.27**	**72,600**	**0.38**	**0.02 (Ave)**
Long term	5.0			35,400	2.83	
Total	45.2			108,000	0.65	

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2020.

1.4.8 **Cash flow and Core cash Investments**. Whilst the authority outperformed the LIBID benchmark by 36 basis points, Interest earned of £72,600 to the end of August is £59,000 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. The potential to mitigate some of that impact is considered in Section 1.6 below.

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 arise 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 schedule for council tax predates 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 (a measure of risk) remains substantially below 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 30 June 2020 the Council's return at 0.34% (purple diamond) was below the local authority average of 0.49%. 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 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 of £35,400 which represents an annualised return of 2.83% (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 primarily due to a delay in the receipt of proceeds from sale of the River Walk offices.

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 / 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.

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 of 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	**448,050**
			Net loss since inception	**6,200**

1.4.20 Since inception, the Council has received dividends from its property fund investments totalling £448,050. Taking the current £454,250 deficit on sale values into account the net loss to the Council is £6,200 (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 Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to August 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 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 2020.

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 2020/21 Treasury Management and Annual Investment Strategy at Audit Committee in January. For ease of reference the parameters included in the Strategy that aim to limit the Council's exposure to investment risks are summarised in **[Annex 5]**.

1.6.2 In undertaking this review **no changes to the current approved risk parameters are proposed at this time**. The Strategy ensures that the Council is investing in high credit quality counterparties and there are an adequate number of counterparties available to maintain a well-diversified portfolio. However, Officers are mindful that investment returns offered by banks and building societies that feature on the Council's lending list have dropped to a fraction of the levels experienced in recent years and that this situation may persist for some time. Having reviewed options with our Treasury Advisor there is little added return to be had from either reducing our minimum credit criteria (Fitch A-, F1) or from extending investment duration beyond current constraints (Link suggested duration plus up to six months for UK institutions). However, we will be looking to expand the Council's lending list to include any UK banks and building societies that don’t currently feature on our lending list but nevertheless meet our minimum credit criteria (potentially one UK bank and two building societies). This will ensure that we can take advantage of all available opportunities as they arise.

1.6.3 We will also be exploring alternative investment options including the use of bond funds and multi-asset income funds. Whilst multi-asset income funds are provided for in our current Strategy, bond funds would be a new addition. Unlike our current bank and building society investments capital values in these types of fund will fluctuate overtime. Investment in these types of product is regarded as medium term typically spanning some three to five years and is therefore dependent on cash balances being sufficient over the medium term to ensure liquidity issues don’t arise. Subject to an understanding and acceptance of the risks, bond funds as an alternative type of investment, may be offered for inclusion in next year’s Annual Investment Strategy. Any investment in either type of fund will of course be dependent on the level of reserves and other balances available for such an investment.

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 (August 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 August 2020 (month five of the financial year) from cash flow surpluses and core cash investments is £59,000 below budget for the same period. Income from property funds at the end of June is below budget by £9,600. Investment income for the year as a whole is expected to underperform against budget by some £237,000. No better and no worse than the figure reported to Audit Committee in July 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 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 Cabinet:

1) Endorse the action taken by officers in respect of treasury management activity for April to August 2020.

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 2020)
Link benchmarking data (June 2020)

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