TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

26 July 2021

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2020/21

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 2020/21 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 June UK GDP having plunged in 2020 had recovered to around 2½% below its 2019 pre-Covid level. Forward looking monthly business surveys are running at exceptionally high levels pointing to a strong economic recovery.

1.2.2 The annual inflation rate (CPI) rose to 2.1% y/y in May from 1.5% y/y in April. The first time CPI has been above the Bank of England's 2% target since July 2019.

1.2.3 After a third wave of the virus threatened to overwhelm hospitals at the start of the year the pace of the UK vaccination programme has boosted confidence that life in the UK could largely return to normal during the second half of 2021. Household saving has been exceptionally high since the first lockdown in March 2020 leaving pent-up demand and purchasing power for services in hard hit sectors like restaurants, travel and hotels. Questions remain over how effective current vaccines will be to mutations of the virus that might emerge and how quickly vaccines can be modified to deal with them.

1.2.4 At the Monetary Policy Committee meeting in June members voted unanimously to keep Bank Rate unchanged at 0.10% and voted by a majority of 8-1 to continue the existing programme of UK government bond purchases at £875bn. In the press release, it was noted that "since May, developments in global GDP growth have been somewhat stronger than anticipated, particularly in advanced economies. Global price pressures have picked up further, reflecting strong demand for goods, rising commodity prices, supply-side constraints and transportation bottlenecks, and these have started to become apparent in consumer price inflation in some advanced economies. Financial market measures of inflation expectations suggest that the near-term strength in inflation is expected to be transitory".

1.2.5 The MPC noted the developing upside risks in the UK to both activity and inflation. It said that the news on activity "had predominately been to the upside" and that Bank staff had "revised up their expectations for 2021 Q2 GDP growth to 5½% from 4¼%". For the first time, the policy statement noted that "there are increasing signs of recruitment difficulties for some businesses" and the minutes said, "it was possible that the near-term upward pressure on prices could prove somewhat larger than expected" and that inflation "is likely to exceed 3% for a temporary period".

1.2.6 Despite the inflationary pressures, previous forward guidance was repeated that the Bank will "ensure that the recovery was not undermined by a premature tightening in monetary conditions" and it will not raise Bank Rate until the 2% inflation target has been attained sustainably.

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. Bank Rate has since risen in 0.25% steps, peaking at 0.75% from August 2018. The pandemic resulted in Bank Rate being cut to 0.1% in March 2020. Link's forecast, updated in May 2021, assumes Bank Rate will continue at this level for the next two years.

Link - May 2020	June-21 %	Sep-21 %	Dec-21 %	Mar-22 %	Jun-22 %	Sep-22 %	Dec-22 %	Mar-23 %	Jun-23 %	Sep-23 %	Dec-23 %	Mar-24 %
Bank Rate	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.25**	**0.25**	**0.25**
3 month ave earnings	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.30**	**0.30**	**0.30**
6 month ave earnings	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.20**	**0.30**	**0.40**	**0.40**	**0.40**
12 month ave earnings	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.20**	**0.30**	**0.30**	**0.40**	**0.50**	**0.50**	**0.50**
25yr PWLB	**2.20**	**2.20**	**2.30**	**2.40**	**2.40**	**2.40**	**2.50**	**2.50**	**2.50**	**2.50**	**2.50**	**2.60**

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 a financial year and are spent by financial year end. Thus far in 2021/22 cash flow surpluses have averaged £23m per day.

1.4.4 The Authority also has £20m 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 £8m to meet business rate appeals of which £3m are expected to be resolved in 2021/22 and the remainder in future years.

1.4.6 Long term investment at the end of June 2021 comprised £5m in property fund investments.

1.4.7 A full list of investments held on 30 June 2021 is provided at **[Annex 1]** and a copy of our lending list of 28 June 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 2021 £m	Weighted average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 30 June 2021 £	Annualised weighted rate of return	LIBID benchmark (average from 1 April 2021) %
Cash flow	21.4	5	0.04	2,100	0.04	-0.08 (7 Day)
Core cash	20.0	156	0.29	14,950	0.33	-0.04(3 Mth)
Sub-total	**41.4**	**78**	**0.16**	**17,050**	**0.17**	**-0.06 (Ave)**
Long term	5.0		3.48	40,350	3.23	
Total	46.4		0.52	57,400	0.50	

1.4.8 **Cash flow and Core cash Investments**. Whilst the authority outperformed the LIBID benchmark by 23 basis points, Interest earned of £17,050 to the end of June is £2,900 below the original estimate for the same period. The fall in income reflects the ultra-low returns on short duration deposits (up to 12 months) available in the market at the present time. Rates declined throughout 2021 in response both the March 2020 Bank Rate cut and the realisation that recovery from the economic impacts of Covid-19 are going to be with us for some time to come.

1.4.9 Bank offers are expected to remain at their current ultra-low levels throughout 2021/22. As a consequence, cash flow and core cash investment is likely to underperform against budget for the year as a whole by some £15,000. Steps are outlined later in the report (Section 1.5) to address this and to mitigate some of the impact a "low Bank Rate for longer" is expected to have on the level of investment income reflected in the Council's Medium Term Financial Strategy (MTFS).

1.4.10 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 31 March 2021 the Council's return at 0.22% (purple diamond) was just above the local authority average of 0.21%. 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.

1.4.11 **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.

1.4.12 £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.

1.4.13 During the period 1 April 2021 to 30 June 2021 the £5m investment in property funds generated income from dividends of £40,350 which represents an annualised return of 3.23%. Income is just below budget to the end of June by £2,150.

1.4.14 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.

1.4.15 Current 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 2021 C £	30 June 21 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	963,750	(36,250)
Lothbury (Primary, July 2017)	1,000,000	927,700	950,350	(49,650)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	995,800	(4,200)
LAPF (Primary, June 2018)	1,000,000	922,200	924,050	(75,950)
Lothbury (Secondary, July 2018)	1,000,000	973,000	932,050	(67,950)
Total change in principal	5,000,000	4,684,100	4,766,000	**(234,000)**
			Total dividends received	**622,950**
			Net gain since inception	**388,950**

1.4.16 Since inception, the Council has received dividends from its property fund investments totalling £622,950. Taking the current £234,000 deficit on sale values into account the net gain to the Council is £388,950. The deficit in sales value is expected to be recouped overtime as the economy improves.

1.4.17 Members are reminded that higher yielding investments (e.g., property, bonds, and 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 criterion. 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 Medium-term investment

1.5.1 In recent years multi asset (diversified income) funds have grown in popularity. The rational for adopting such a fund was explored in the Audit Committee report of January 2018 and their use for medium-term investment reaffirmed in the

January 2021 Audit Committee report which introduced this financial year's Annual Investment Strategy.

1.5.2 Like property funds, multi asset funds aim to generate returns over and above inflation and thus preserve spending power. The March 2020 cut in bank rate and its impact on the level of investment income in the early years of our MTFS provided added impetus to progress such an investment and provide some mitigation against a "low Bank Rate for longer".

1.5.3 By their nature investment in a multi asset fund will involve exposure to shares and bonds issued by companies. It isn't practical to exclude specific types of company activity (e.g. tobacco, oil and gas exploration etc). To do so might preclude investment in such a fund. An informal Member meeting was held in March comprising the Leader of the Council, Cabinet Member for Finance Innovation and Property, Cabinet Member for Street Scene and Environmental Services, Chairs of Audit Committee and the Finance Innovation & Property Advisory Board. The meeting concluded with a set of criteria that would focus on a fund's ESG (environmental, social and governance) and investment management credentials. The agreed criteria were:

- Does the fund have and ESG policy?
- How is ESG policy applied in the decision to purchase, hold and sell investments?
- Has the fund manager adopted the UK Stewardship Code?
- Does the fund manager apply the UN Principles of Responsible Investment?
- Does the fund manager participate in the Institutional Investors Group on Climate Change (IIGCC)?

The first four criteria were considered necessary to attract the Council's investment. The final criteria, though not a must, was considered highly desirable.

1.5.4 Link were engaged to support the selection process. From a longlist of seventeen potential funds Link considered appropriate for Local Authority treasury investment, twelve were selected for detailed evaluation. In response to a questionnaire the qualitative and quantitative analysis undertaken by Link culminated in five funds being selected for presentation / interview. The presentations were held on 29 June 2021.

1.5.5 All the funds invited to present met the criteria outlined in paragraph 1.5.3 including membership of the IIGCC. Three funds have now been selected for investment with an expectation based on past performance that, each will deliver a return in excess of 3% per annum and preserve capital over the five-year duration of the investment. The three funds selected are:

- Fidelity Multi Asset Income Fund.
- Ninety One Diversified Income Fund.
- Aegon Diversified Monthly Income Fund.

1.5.6 Link's fee for the engagement is £8,500 and is to be funded from the additional income that the investment will generate in the current financial year. Application forms are currently being processed. £1m is being invested in each of the three named funds which collectively are expected to generate £60,000 of additional income in 2021/22 (£90,000 in a full year).

1.6 Compliance with the Annual Investment Strategy

1.6.1 Throughout April to June 2021, all the requirements contained in the 2021/22 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 2021.

1.6.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The 2021/22 Prudential and Treasury Indicators will be included for review as part of the treasury management report to the September 2021 meeting of Audit Committee.

1.7 2020/21 Treasury Management Outturn

1.7.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 2 June 2021 as an annex to the Revenue and Capital Outturn report for 2020/21. 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.

1.7.2 A summary of the investment performance included in Annex 4 is as follows:

	2020/21 Average balance £m	Return %	2020/21 Interest/ dividends earned £	2020/21 Revised Estimate £	Variance Better (worse) £
Cash flow surpluses	29.3	0.13	36,821	42,000	(5,179)
Core cash	17.4	0.53	91,955	90,000	1,955
Long term investment	5.0	3.42	172,177	156,000	16,177
Total	51.7	0.58	300,953	288,000	12,953

1.7.3 The combined performance of the Authority's investments exceeded the revised estimate by £12,953 but were £224,047 less than the 2020/21 original estimates reflecting the Covid-19 impact on investment returns.

1.7.4 Income and expenditure attributed to the Treasury Management function for 2020/21 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.

1.8 Legal Implications

1.8.1 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.

1.9 Financial and Value for Money Considerations

1.9.1 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 (updated May 2021) anticipates Bank Rate remaining at 0.1% for the next two years.

1.9.2 Investment income at the end of June 2021 (month three of the financial year) from cash flow surpluses and core cash investments is £2,900 below budget for the same period. Income from property funds at the end of June is below budget by £2,150. Investment income for the financial year as a whole from these sources is expected to underperform against budget by some £15,000.

1.9.3 Arrangements are in hand to invest £3m in multi asset funds. The investment is expected to generate a return in excess of 3% per annum. The return is significantly higher than that currently being derived from core fund deposits. After deducting Link's engagement fee (£8,500) the additional net income in 2021/22 will be some £51,500.

1.9.4 Investment income for the 2020/21 financial year as a whole exceeded the revised estimate by £12,953 (£224,047 less when compared to the original 2020/21 estimate).

1.9.5 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.

1.9.6 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.

1.9.7 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.

1.9.8 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.

1.9.9 Multi asset (diversified income) funds aim to limit risk by spreading investment across a broad range of asset classes (equities, bonds, property, cash). Nevertheless, the principal sum invested may fall as a consequence of adverse economic or market events. Multi asset funds are being used for medium-term investment implying a five-year timeframe.

1.9.10 The investment in multi asset funds assumes balances available for investment in the final year of our 10-year MTFS will be circa £15m. The MTFS includes a series of savings targets which have yet to be delivered.

1.10 Risk Assessment

1.10.1 The application of best practice, including the regular reporting and scrutiny of treasury management activity, as identified by the CIPFA Code is considered an effective way of mitigating the risks associated with treasury management.

1.11 Equality Impact Assessment

1.11.1 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act.

1.12 Recommendations

1.12.1 Members are invited to **RECOMMEND** that Council:

1) Endorse the action taken by officers in respect of treasury management activity for April to June 2021.

2) Note that £3m is being applied to investment in multi asset (diversified income) funds.

3) Note the 2020/21 outturn position.

Background papers: contact: Mike Withey

Link interest rate forecast (May 2021)
Link benchmarking data (March 2021)

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