TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

27 September 2021

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 201/22 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 2021/22 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2021/22.
- A review of the risk parameters contained in the 2021/22 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 4 August at 0.1%. The MPC also maintained the level of quantitative easing (QE) at £895bn. The Bank's forecasts were adjusted to reflect:

- The annual GDP growth forecast for 2021 was revised up from 5.0% in February to 7.25%, the fasted pace of growth since 1940s. Growth was revised down in 2022 by a slightly smaller amount (7.25% to 5.75%). The bank now expects GDP to return to its pre-crisis peak in Q4 2021 rather than previously indicated in Q1 2022.
- The unemployment rate is expected to peak at 5.4% in Q3 2021, rather than 7.8% in Q3 2021 as previously stated.
- The MPC decided to slow the pace of its asset purchases from £4.4bm per week so that it could stay on track to hit its target for QE by the end of the year.
- Only one MPC member voted to stop the asset purchases now to leave total purchases £45bn short of the total QE target.

1.2.2 There has been a major shift from previous MPC decisions over the last year from indicating no expected tightening any time soon, to now flagging up that interest rate increases were now on the horizon. While some members felt that there would be no tightening of policy until inflation is sustained at the 2% target, they all agreed that some modest tightening of monetary policy over the forecast period was likely to be necessary to be consistent with meeting inflation target sustainably in the medium term.

1.2.3 At the current time, the MPC forecasts are showing inflation close to 2% target in 2 to 3 years' time. The initial surge in inflation in 2021 and 2022 is due to a combination of base effects, one off energy price increases and a release of pent-up demand particularly from consumers who have accumulated savings during the pandemic which are hitting supply constraints. However, these effects will gradually subside.

1.2.4 The MPC concluded its review of monetary policy as to whether it should raise Bank Rates before reducing its balance sheet (QE) holding of bonds. The focus will be initially on raising the Bank Rate and it is expected that it will start to reduce its holdings once the rate is 0.50%.

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 2021/22 Investment Strategy assumed economic conditions would continue to improve requiring a gradual rise in Bank Rate over the next three years.

Link - Nov 2020	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	0.10	0.10
3 mth ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 mth ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 mth ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
25yr PWLB	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80

Table 1 (a)

1.3.2 The world has changed due to the Covid-19 pandemic which has seen both Government and Central Bank intervention over the past 18 months being historic in magnitude. Interest rate forecasting is now much more problematic and tentative than it is in normal circumstances. Whilst lockdown measures are now relaxed, the full extent of the economic impacts is still uncertain.

1.3.3 Link updated their forecast in August 2021 as follows:

Link - August 2021	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	0.25	0.25	0.25	0.50
3 mth ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.30	0.30	0.30	0.50
6 mth ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.20	0.30	0.40	0.50	0.50
12 mth ave earnings	0.20	0.20	0.20	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.70
25yr PWLB	1.90	2.00	2.10	2.20	2.30	2.30	2.30	2.40	2.40	2.40	2.50

Table 1 (b)

1.3.4 The forecast is based on the success of the vaccine programme roll out and the inflation spike will be short lived. In addition:

- On-going market volatility will no longer need Government and Central Bank intervention.

- Bank Rate will stay at 0.1% with the first increase factored in for June 2023.
- High inflation due to temporary increases in commodity and component prices will be reversed in 2022.
- The result is expected to be a very flat yield curve for at least a year and only marginal increases over the following year.

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 and medium 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 2021/22 cash flow surpluses have averaged £26.2m.

1.4.4 The Authority also has £19m 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 2021/22 and the remainder in future years.

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

1.4.7 Medium term investments at the end of August 2021 comprised £3 in multi asset fund investments.

1.4.8 A full list of investments held on 31 August 2021 is provided at **[Annex 1]** and a copy of our lending list of 31 August 2021 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 2021 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 31 August 2021 £	Gross annualised return %	LIBID benchmark (average) 1 April to 31 August 2021 %
Cash flow	25.7	4	0.03	3,900	0.04	-0.08(7 Day)
Core cash	19.0	171	0.28	25,000	0.31	-0.04 (3 Mth)
Sub-total	**44.7**	**75**	**0.14**	**28,900**	**0.15**	**-0.07 (Ave)**
Long term	5.0			40,400	3.23	
Medium term	3.0			0	0	
Total	**52.7**			**69,300**	**0.34**	

Table 2

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2021.

1.4.9 **Cash flow and Core cash Investments**. Whilst the authority outperformed the LIBID benchmark by 22 basis points, interest earned of £28,900 to the end of August is below the original estimate for the same period. The fall in income is due to the continued low Bank Rate offered in the current market as well as consumer accumulated savings further reducing the financial institutions requirement to source funding.

1.4.10 The bank offers are expected to remain at their current ultra-low levels throughout 2021/22, however, the introduction of multi-asset funds will compensate the shortfall in income associated with cash flow and core cash investments. It is projected that the investments will underperform by some £15k at year end.

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 2021 the Council's return at 0.16% (purple diamond) was below the local authority average of 0.17%. 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 2021 to 30 June 2021 the £5m investment in property funds generated dividends of £40,400 which represents an annualised return of 3.23% (2.83% in 2020/21). The property funds have shown signs of recovery from Covid-19 which is reflected in the dividend being distributed. It is expected that performance of the funds will be in line with the original budget set for 2021/22.

1.4.16 The sale of River Walk offices are expected to have concluded by the end of the fiscal year which will provide additional funds in the region of £1.5m. There will be consideration given to determine how best to optimise a return from the capital receipt.

1.4.17 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.

1.4.18 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. The Covid-19 impact on the economy is contributed to a further decline in commercial property values in 2020/21. The first quarter of 2021/22 has shown signs that a steady recovery has now commenced.

1.4.19 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.

1.4.20 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 2021 C £	30 June 21 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	963,770	(36,230)
Lothbury (Primary, July 2017)	1,000,000	927,700	950,360	(49,640)
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	4,766,030	**(233,970)**
			Total dividends received	**622,950**
			Net gain since inception	**388,980**

Table 3

1.4.21 Since inception, the Council has received dividends from its property fund investments totalling £622,950. Taking the current deficit on sales value of £233,970 into account, the net gain generated to the Council is £388,980. The effect on the economy and commercial property values due to of Covid-19 saw a decreased in the property fund values. The funds values at 30 June 2021 have increase by £220,000 over the past 12 months and values are nearing pre Covid-19 levels. Fund values are expected to continue to improve as the economy continues its recovery.

1.4.22 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.

1.4.23 **Medium term Investment**. 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.

1.4.24 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".

1.4.25 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 and three funds were 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.

1.4.26 A total of £3m has been invested equally between Fidelity Multi Asset Income Fund, Ninety-One Diversified Income Fund and Aegon Diversified Monthly Income Fund in July and August. The expected return for the remainder of 2021/22 should generate an additional £52,500 which will offset the cost of Link's engagement (£8,500) and the projected deficit in income generated from the cash and core investments.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to August 2021 all of 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 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 2021.

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 There is a need to continue to explore alternative investment options to ensure the maximum return on investment for the Council. Subject to an understanding and acceptance of any associated risks with such investments, they may be offered for inclusion in next year's Annual Investment Strategy. Any investment 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 ongoing impact of Covid-19 on the economy, BoE cut Bank Rate to 0.1% in March 2020. Link's current forecast (August 2021) anticipates Bank Rate remaining at 0.1% for at least the next eighteen months.

1.8.2 Following the continued low Bank Rate, investment income at the end of August 2021 (month five of the financial year) from cash flow surpluses and core cash investments is forecast to be £4,400 below budget for the same period. Income from property funds at the end of June is below budget by £2,100. Investment income for the year as a whole is expected to underperform by some £15,000. No better and no worse than the figure reported to Audit Committee in July 2021.

1.8.3 However, in factoring in the additional income expected from the £3m investments in multi asset funds for the remainder of 2021/22, the revised overall position will be some £29,000 favourable variance against the original budget.

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 and multi asset investments from existing resources is expected to be available in perpetuity. Nevertheless, the Council's cash balances will continue to be monitored and due regard is given 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 or assets 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 2021.

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

Background papers: contact: Donna Riley

Link interest rate forecast (August 2021)
Link benchmarking data (June 2021)

Sharon Shelton
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