TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

24 January 2022

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT UPDATE AND TREASURY MANAGEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2022/23

The report provides details of investments undertaken and return achieved in the first nine months of the current financial year and an introduction to the 2022/23 Treasury Management and Annual Investment Strategy. Members are invited to recommend adoption of the Strategy to Cabinet.

1.1 Introduction

1.1.1 The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are 'affordable, prudent and sustainable'.

1.1.2 The Act also requires the Council to set out its Treasury Management Strategy for borrowing and to prepare an Annual Investment Strategy. The latter sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.2 Interest Rate Forecast

1.2.1 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 remain at 0.1% over the next three years.

1.2.2 The world has continued to evolve since the beginning of Covid-19 with the vaccination rollout deemed a success, scientists worked against the clock to produce new and effective vaccines against the various mutations being discovered. Since the 2021/22 Strategy was published last February there has been a shift in appetite to increase the interest rate, and although we are expecting to see interest rate rises in the coming months, forecasting is still problematic and tentative than it is in normal circumstances.

1.2.3 The Bank of England became the first major western central bank to put interest rates up to 0.25% in December 2021 and there is further expected rate increases in the coming months to alleviate rising inflation rates. The Bank of England have advised that once the bank rate has increased to 0.50%, they will start to reduce Quantitate Easing (QE) and will allow current investments specifically targeted at QE to mature.

1.2.4 Link's latest Bank Rate forecast, updated in December 2021, is included in **[Annex 5]** and anticipates the Bank Rate rising to 1.25% over the next three years to March 2025.

1.3 Investment Performance

1.3.1 The Council's investments are derived from cash flow surpluses, core cash balances and other long term cash balances.

1.3.2 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 £12.5m.

1.3.3 The Authority also has £22m 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.

1.3.4 Cash flow and core cash balances also includes some £10m to meet business rate appeals of which £3m are expected to be resolved in 2021/22 and the remainder in future years.

1.3.5 Long term investment comprises £5m in property fund investments.

1.3.6 Medium term investment comprises £4.25m in diversified income fund investments.

1.3.7 A full list of investments held on 31 December 2021 is provided at **[Annex 1]** and a copy of our lending list of 31 December 2021 is provided at **[Annex 2]**. The table below provides a summary of funds invested and income earned at the end of December.

	Funds invested on 31 December 2021 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 31 December 2021 £	Gross annualised return %	LIBID benchmark (average) 1 April to 31 December 2021 %
Cash flow	36.2	3	0.09	5,960	0.03	-0.08(7 Day)
Core cash	22.0	120	0.3	42,410	0.29	-0.03 (3 Mth)
Sub-total	**58.2**	**48**	**0.17**	**48,370**	**0.14**	**-0.05 (Ave)**
Long term	5.00			78,000	3.1	
Medium term	4.25			43,100	3.0	
Total	**67.4**			**169,470**	**0.74**	

Table 1

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

1.3.8 **Cash flow and core cash investments**. Whilst the authority outperformed the LIBID benchmark by 19 basis points, Interest earned of £48,370 to the end of December is £11,630 below the original budget estimate for the same period. The fall in income is due to investment rates remaining low since the emergency cuts in Bank Rate in March 2020 and the impact on investment opportunities.

1.3.9 Audit Committee were made aware at their July and September meetings of the potential shortfall in income for the year as a whole if bank offers persisted at ultra-low levels throughout 2021/22. The revised estimates for 2021/22 have been adjusted to incorporate the adverse variance in cash and core investment income.

1.3.10 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. As at 30 September 2021 the Council's return at 0.14% (purple diamond) was inline with the local authority average. 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.

1.3.11 Only cash flow and core cash returns form part of the benchmarking data. The additional return the Council makes from its property fund investments is not included. The data also excludes any short term borrowing costs authorities may have incurred to meet payment obligations. To address the cash flow uncertainties that Covid-19 has generated this Council has maintained much higher levels of daily liquidity than would otherwise have been the case. As a consequence no borrowing costs have been incurred to date and none are anticipated during the remainder of 2021/22.

1.3.12 **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.

1.3.13 £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 could be made in the future as resources become available from asset disposals and other windfalls.

1.3.14 During the period 1 April 2021 to 30 September 2021 the £5m investment in property funds generated dividends of £78,000 which represents an annualised return of 3.1% (3.1% in 2020/21). Covid-19 has resulted in a proportion of rents due to be collected being deferred. In the third quarter fund managers reported that over 80% of rents due had been paid with the remaining expected at some point during the current financial year. Income from property funds is expected to be in line with the budget for the financial year as a whole.

1.3.15 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.

1.3.16 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. During spring and summer 2020 the Covid-19 impact on the economy saw commercial property values decline at a faster rate. However, there are strong indicators that recovery is underway and demand for commercial property units has shown signs of increase in the later part of 2021. It was reported to Audit Committee in September 2021 that the principal investment in the property funds is close to pre-covid 19 levels.

1.3.17 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 attributed “uncertainty” to their monthly valuations during the summer. 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 was welcomed. Trading of shares has now resumed.

1.3.18 Sale values at the end of November vs initial purchase prices 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 November 2021 C £	30 November 21 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	1,023,440	23,440
Lothbury (Primary, July 2017)	1,000,000	927,700	1,000,820	820
Hermes (Secondary, Oct 2017)	1,000,000	939,000	1,060,080	60,080
LAPF (Primary, June 2018)	1,000,000	922,200	981,270	(18,730)
Lothbury (Secondary, July 2018)	1,000,000	973,000	981,520	(18,480)
Total change in principal	5,000,000	4,684,100	5,047,130	**47,130**
			Total dividends received to September 2021	**660,580**
			Net benefit since inception	**707,710**

Table 2

1.3.19 Since inception, the Council has received dividends from its property fund investments totalling £660,580. The change in sales value on the principal investment within the property portfolio has exceeded the original purchase price, therefore as at November 2021, the capital investment has appreciated in value by £47,130. With the economy showing signs of recovery, this is the first time since the impact of Covid-19 we are able to report the capital growth has exceeded the cost of the original investment.

1.3.20 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.

1.3.21 **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 the multi asset funds into the 2021/22 Annual Investment Strategy.

1.3.22 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".

1.3.23 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

1.3.24 A total of £3m was initially invested equally between Fidelity Multi Asset Income Fund, Ninety-One Diversified Income Fund and Aegon Diversified Monthly Income Fund in July and August, with a further £1.25m invested in November 2021 across Aegon and Ninety-One with the proceeds from the sale of Riverwalk offices. Additional multi asset fund investments could be made in the future as resources become available from asset disposals and other windfalls.

1.3.25 During the period July 2021 to December 2021 the £4.25m investment in multi asset funds generated dividends of £43,100 which represents an annualised return of 3%. In the third quarter fund managers reported continued growth in the portfolios and in particular, infrastructure projects are providing healthy returns.

1.3.26 **Treasury management function**. Income and expenditure estimates attributed to the Treasury Management function are provided at **[Annex 4]**. 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 expected to increase as Bank Rate rises. Expenditure is expected to rise in-line with inflation.

1.4 Annual Investment Strategy for 2022/23

1.4.1 The Council's treasury advisor anticipates bank rate rising over the next three years in increments of 0.25% in order to counter the high levels of inflation we are currently experiencing and to promote the UK's economic growth. The expectation is we will see two incremental rate rises in 2022/23 and further stepped rates rises over the following two years to 2024/25 slowly increasing the bank rate to 1.25%. However, the timing of the bank rate rises is hard to predict as it is recognised that there is likely to be further mutations of Covid-19, which may change the landscape once more.

1.4.2 The ultra-low bank rate has resulted in offers for deposits falling to extraordinarily low levels (paragraph 1.2.4) which makes generating a worthwhile return from our traditional term deposits with banks and building societies unrealistic at the present time. Bank offers have improved a little following the MPC's decision in December 2021 to move the bank rate to 0.25%. Nevertheless the improvement has amounted to no more than a few basis points which will add little to overall earnings. Going forward earnings are anticipated to be but a fraction of those generated in recent years.

1.4.3 The returns on our **property fund investments**, though representing only 7.37% of 2021/22 investment portfolio, are likely to generate some 43% of next years' income. The property fund investments are long term (10 year) investments. As a consequence of the high entry / exit costs (circa 8%) and potential for significant volatility in capital values, our strategy limits exposure to property funds from existing resources to 20% of expected long term balances, circa £3m per fund.

1.4.4 The returns on our **diversified income fund investments**, though representing only 6.27% of 2021/22 investment portfolio, are likely to generate some 40% of next years' income. The diversified income fund investments are medium term (5 year) investments. As a consequence of the potential for significant volatility in capital values, our strategy limits exposure to diversified income funds from existing resources to 20% of expected long term balances, circa £3m per fund.

1.4.5 Diversified income fund investment typically implies a 5 year commitment to negate volatility in capital values over the life of the investment.

1.4.6 There are no proposed changes for the 2022/23 strategy. However, the treasury team continuously monitor the market for potential investment which may align with the Council's strategic plans, and which would provide additional revenue streams.

1.4.7 **Risk parameters**. The Strategy sets out the parameters that limit the Council's exposure to investment risks by requiring overnight and term deposits to be placed with highly credit rated institutions and that those investments are diversified across a range of counterparties. The 2022/23 Annual Investment Strategy **[Annex 5]** adopts the same risk parameters as currently approved. In summary these are:

- 100% of funds can be invested in the UK. Exposure to non-UK institutions is restricted to no more than 20% of funds per sovereign.

- Non-UK counterparties must be regulated by a sovereign rated AA- or higher as recognised by each of the three main rating agencies (Fitch, Moody’s or Standard & Poor’s).

- Investment in UK institutions is subject to the UK sovereign being rated A- or higher by each of the three main rating agencies. The UK currently receives a rating of AA- from Fitch and Moody’s and AA from Standard and Poor’s.

- Exposure to individual counterparties / groups of related counterparty must not exceed 20% of funds or 10% of funds if a housing association.

- In selecting suitable counterparties for overnight deposits and deposits up to 2 years in duration (3 years with a local authority), the Council has adopted Link’s credit worthiness methodology. The methodology combines the output from all three credit rating agencies including credit watches / outlooks and credit default swap data to assign a durational band to a financial institution (100 days, 6 months, 1 year, 5 years, etc.). At the time of placing an investment the financial institution must be assigned a durational band of at least 100 days (based on credit ratings alone). Other than for UK nationalised institutions this broadly equates to a minimum long term credit rating of Fitch A- (high) and a short term credit rating of Fitch F1 (highest).

- Investment in UK nationalised banks is subject to the bank having a minimum long term credit rating of Fitch BBB (good) and a short term credit rating of Fitch F2 (good*).* The Royal Bank of Scotland and National Westminster Bank are currently rated Fitch A+, F1.

- The duration of an investment in a foreign bank must not exceed Link’s post CDS recommendation. For UK financial institutions Link’s duration recommendation can be enhanced by up to 6 months subject to the combined duration (Link recommendation plus the enhancement) not exceeding 12 months. The Council’s Treasury Management Practices have been modified to ensure that where duration is being enhanced by more than 3 months the bank’s CDS must be below the average for all other banks at the time the investment is placed.

- Money Market funds will be AAA rated and exposure limited to no more that 20% per fund. LVNAV (low volatility) or VNAV (variable net asset value) funds may be used as an alternative to CNAV (constant net asset value) funds.

- Enhanced cash and Government liquidity funds will be AAA rated and ultra-short duration bond funds rated AA or higher. Exposure is limited to no more than 10% of investment balances per fund and 20% to all such funds.

- Exposure to non-credit rated property funds is limited to no more than 20% (£3m) of expected long term cash balances. No limit applies where invested funds are derived from or in anticipation of new resources e.g. proceeds from selling existing property.

- Exposure to non-credit rated diversified income (multi-asset) funds and or short dated bond funds is limited to no more than 20% (£3m) of expected long term cash balances per fund and across all such funds.

- The strategy also limits the type of instrument (e.g. fixed term deposits, certificates of deposit, commercial paper, floating rate notes, treasury bills, etc.) that can be used and establishes a maximum investment duration for Gilts of 5 years, 3 years for deposits with local authorities and 2 years for all other types of investment other than investment in property funds, diversified income funds and short dated bond funds.

- The strategy includes prudential indicators for borrowing. Whilst there is no expectation that the Council will need to borrow to fund its capital expenditure proposals prior to 2028/29, borrowing on a temporary basis may be required to meet payment obligations. Borrowing limits are expressed as the operational limit (£4m) and authorised limit (£7m). Our largest monthly outflows relate to business rates and precept payments circa £5m each. Whilst those payments tend to fall on different days of the month that is not always the case. The limits are a precautionary measure to allow borrowing on a short term basis should the need arise. In recent years the Council's cash flows have been managed in such a way that no overdraft fees or temporary borrowing costs have arisen.

1.4.8 The 2022/23 Strategy **[Annex 5]** reflects the current economic environment, Link Asset Services' latest interest rate forecast and incorporates the risk parameters summarised in paragraph 1.4.7.

1.5 Non-treasury Management Practices

1.5.1 The authority is currently debt free, and no borrowing is forecast to meet the Council's capital expenditure proposals prior to 2028/29. This does not however, preclude a decision to borrow in order to fund in full or in part an investment opportunity that meets the Council's strategic priorities and objectives, achieves value for money and delivers a financial return. Each such opportunity to be considered on a case by case basis as appropriate.

1.5.2 At present the Council has no material non-treasury investments, e.g. expenditure on loans or the acquisition of non-financial assets (property) intended to generate a profit. The report to Audit Committee 20 January 2020 made reference to procedures that would need to be adopted to ensure compliance with the Chartered Institute of Public Finance & Accountancy's Treasury Management and Prudential Codes of Practice 2017 and the 2018 Statutory Guidance on Local Government Investments relating to non-treasury investments. Accordingly, a practice note was prepared and endorsed at the Audit Committee meeting in January 2021 and is attached at **[Annex 6]** for information.

1.6 Legal Implications

1.6.1 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.

1.6.2 This report fulfils the requirements of the Chartered Institute of Public Finance & Accountancy's Treasury Management and Prudential Codes of Practice 2017 and the 2018 Statutory Guidance on Local Government Investments. Please note, both Codes have been updated in December 2021, and we will need to consider the implications to future updates to the Treasury Management and Annual Investment Strategy.

1.7 Financial and Value for Money Considerations

1.7.1 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. In December 2021, the Bank of England (BoE) returned the Bank Rate to 0.25%. Link's current forecast (December 2021) anticipates Bank Rate rising to 1.25% over the next three years to March 2025.

1.7.2 Following the March 2020 cut in Bank Rate, investment income at the end of December 2021 (month nine of the financial year) from cash flow surpluses and core cash investments is £11,630 below original budget for the same period. Income from property funds at the end of September is below original budget by £7,000 for the same period. Investment income from multi-asset funds since inception have generated £43,100 of unbudgeted income. Investment income for the year as a whole is expected to exceed the original budget by £46,100.

1.7.3 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.

1.7.4 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.

1.7.5 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.

1.7.6 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 12 months. Funds will seek to minimise their own cash balances in favour of holding property and therefore manage redemption requests for the benefit of all fund participants. The Council is only likely to seek redemption to pursue a higher yielding income opportunity should one be identified.

1.7.7 Diversified income funds aim to limit risk by spreading investment across a broad range of asset classes (equities, bonds, property and cash). Nevertheless, the principal sum invested may fall as a consequence of adverse economic or market events.

1.7.8 Short term bond values are linked to interest rate expectations and long term bond values are linked to inflation expectations. Funds aim to minimise the risk of issuer default by investing in a broad spread of issuers and across different sectors and geographic regions. Nevertheless, the principal sum invested may fall as a consequence of adverse economic or market events.

1.8 Risk Assessment

1.8.1 Link Asset Services are employed to provide advice on the content of the Treasury Management and Annual Investment Strategy and this, coupled with a regular audit of treasury activities ensures that the requirements of the Strategy and the Treasury Policy Statement adopted by this Council are complied with.

1.8.2 Credit ratings remain a key tool in assessing risk. It is recognised that their use should be supplemented with sovereign ratings and market intelligence. Appropriate sovereign, group and counterparty limits are established to ensure an appropriate level of diversification.

1.8.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2022/23 Strategy have been minimised.

1.9 Equality Impact Assessment

1.9.1 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

1.10 Recommendations

1.10.1 Members are invited to **RECOMMEND** that Cabinet:

1) Note the treasury management position as at 31 December 2021.

2) Adopts the Treasury Management and Annual Investment Strategy for 2022/23 set out at **[Annex 5)**.

Background papers: contact: Donna Riley

Link Asset Services: Interest rate forecast (December 2021), economic commentary and benchmarking data.

Sharon Shelton
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