TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

06 October 2014

Report of the Director of Finance & Transformation

Part 1- Public

Matters for Recommendation to Cabinet – Council Decision

1 TREASURY MANAGEMENT MID-YEAR REVIEW 2014/15

This report provides an update on treasury management activity undertaken during the period April to August of the current financial year. Members are reminded of the parameters that define the Council's risk appetite and of the arrangements for managing the Council's investments. Members are invited to endorse the action taken by officers in respect of treasury management activity to date, to retain the current risk parameters and note the change in management responsibility for the Council's core fund investments.

1.1 Introduction

1.1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 18 February 2010.

1.1.2 The primary requirements of the 2009 Code and its subsequent revisions 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 CIPFA's Code of Practice, and covers the following:

- An economic update and revised interest rate forecast.
- Investment performance for April to August of the 2014/15 financial year.
- The current investment portfolio and associated management arrangements.
- Borrowing.
- Compliance with Treasury and Prudential Limits for 2014/15.
- A review of the risk parameters contained in the 2014/15 Annual Investment Strategy.

1.2 Economic Background

1.2.1 The strong growth experienced in the UK throughout 2013 has continued in the first two quarters of 2014 (0.8% in Q1 and Q2 of 2014 which equates to an annual rate of 3.2%). Strong growth is expected to continue throughout 2014 as forward surveys for the services and construction sectors are very encouraging and business investment is improving. However, sustained economic recovery in the longer term will require a rebalancing away from dependence on consumer expenditure and the housing market towards manufactured goods and exports.

1.2.2 Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. The sharp fall in inflation (CPI) down to 1.5% in May, the lowest rate since 2009, is also encouraging. Forward indications are that inflation is likely to fall further in 2014 to something near 1%. Overall, markets are expecting that the Bank of England Monetary Policy Committee (MPC) will be cautious in raising the Bank Rate as it will want to protect heavily indebted consumers from too early an increase at a time when inflationary pressures are weak. A first increase in Bank Rate is expected in Q1 or Q2 of 2015 and increases after that are expected to be at a slow pace and ultimately rise to a lower level than that prevailing before 2008.

1.2.3 The UK's major trading partner, the Eurozone, is facing increasing threats from weak or negative growth and from deflation. The European Central Bank (ECB) took limited action in June to loosen monetary policy in order to promote growth. In August, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all Eurozone countries and includes some countries with negative rates of inflation. In September the ECB took further action to cut its benchmark rate (the equivalent of our Bank Rate) to only 0.05% and started a programme of corporate debt purchases. The ECB has not yet embarked (it may never) on a programme of full quantitative easing (purchase of sovereign debt).

1.2.4 In the US the Federal Reserve continued to reduce its programme of asset purchases. Complete cessation of the programme is a precursor to rising interest rates in America. Asset purchases have now fallen from $85bn per month in December 2013 to $25bn in July 2014. Providing strong growth continues the programme is expected to come to an end in October 2014.

1.3 Interest Rate Forecast

1.3.1 The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

Rate	Now %	Dec-14 %	Mar-15 %	Jun-15 %	Sep-15 %	Dec-15 %	Mar-16 %	Jun-16 %	Sep-16 %	Dec-16 %
Bank Rate	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.75**
3 mth LIBID	**0.50**	**0.60**	**0.80**	**0.80**	**1.10**	**1.10**	**1.30**	**1.40**	**1.60**	**1.90**
6 mth LIBID	**0.60**	**0.80**	**0.90**	**1.00**	**1.15**	**1.20**	**1.40**	**1.50**	**1.80**	**2.00**
12 mthLIBID	**0.80**	**1.00**	**1.00**	**1.20**	**1.30**	**1.40**	**1.70**	**1.80**	**2.10**	**2.20**
25yr PWLB	**4.00**	**4.10**	**4.20**	**4.30**	**4.40**	**4.50**	**4.60**	**4.70**	**4.80**	**4.80**

Downside risks to the forecast include:

- UK strong economic growth is currently dependent on consumer spending and an unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partners - the EU and US, inhibiting economic recovery in the UK.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the issues.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates.
- Monetary policy action failing to stimulate sustainable growth in western economies especially the Eurozone but also Japan.
- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years, plus the significant QE measures which remain in place has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns (a return of the environment which led to the 2008 financial crisis).

1.4 Investment Portfolio

1.4.1 The Annual Investment Strategy for the 2014/15 financial year was approved by Council on 18 February 2014. The Strategy outlines the Council's investment priorities as follows:

- Security of Capital,
- Liquidity.

1.4.2 In addition the Council aims to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In particular, for 2014/15 the Council will 'avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile'. The Council has adopted Capita's recommended creditworthiness approach which incorporates the credit ratings from each of the three main rating agencies and includes sovereign credit ratings and a market view of risk using credit default swap data.

1.4.3 A full list of investments held on 31 August 2014 and our internal lending list in operation on that date are shown in **[Annexes 1 and 2]** of this report.

1.4.4 As illustrated above, investment rates available in the market are at an historical low point. The average level of cash flow funds available for investment purposes to the end of August 2014 was £10.0m. These funds were available on a temporary basis and the amount mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The Authority holds £13.4m of core cash balances for investment purposes. These funds are for the most part available to invest for more than one year, albeit some funds will need to be recalled towards the end of the financial year to top-up our daily cash balances. Responsibility for the management of core funds transferred from the Council's external fund manager to In-house management on 1 August 2014.

1.4.5 At the end of August 2014 funds invested and interest earned is set out in the table below:

	Funds invested at 31 August 2014	**Average duration to maturity**	**Weighted average rate of return**	**Interest earned to 31 August 2014**	**Gross annualised return**	**7 day LIBID benchmark**
	£m	**Years**	**%**	**£**	**%**	**%**
In-house cash flow	8.2	0.15	0.73	27,600	0.66	0.35
Externally managed core funds to 31 July	-	0.78 [1]	0.61 [1]	25,500	0.57	0.35
In-house managed core funds from 1 August	13.4	0.82	0.71	7,300	0.64	0.35
Total	21.6	0.57	0.72	60,400	0.62	0.35

[1] Figures shown for comparative purposes represent the values applicable to the externally managed portfolio on 31 July, the day before transfer to In-house management.

1.4.6 Interest earned of £60,400, whilst 27 basis points better than benchmark, is £9,400 below budget expectations. The shortfall against budget is attributed to the relatively poor performance achieved by the external fund manager in the early part of the year.

1.4.7 **Cash Flow Funds**. Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations. When cash surpluses permit fixed term investments are undertaken to take advantage of the higher yields available.

1.4.8 The Council participates in Capita's benchmarking service which enables the Council to gauge its in-house performance against Capita'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 30 June 2014 our return (purple diamond) was the highest of the other Kent benchmarking group authorities and above the average for all other local authorities. Our return also outperformed that anticipated by the model based on our exposure to credit / duration risk.

1.4.9 **Core Funds**. Historically, these funds have been managed by an external fund manager and are being used to support both revenue and capital expenditure over the next few years of our medium term financial strategy as the Council grapples with savings targets to achieve a balanced budget. The core fund balance of £13.4m (expected to reduce to circa £11m by the end of the financial year) is at a level where In-house management is practical without the need for additional staff resources. The 2014/15 Annual Investment Strategy (considered by Audit Committee in January 2014) made provision for these funds to be transferred to In-house management by the end of the financial year and thus contribute to future savings targets through reduced fund management fees. I'm pleased to report that the transfer to In-house management took place on 1 August 2014.

1.4.10 On 1 August all tradable instruments (Gilts, Treasury Bills and Certificates of Deposit) which comprised the lion's share (£12.6m) of the core fund were transferred to the Council's custody account with King & Shaxon and the cash balance (£0.8m) transferred to the Council's bank account. With the exception of the Gilts (£2.2m, maturing 2018) the fund manager's preference for short duration instruments, typically three months in duration, explains the poor performance referred to at paragraph 1.4.6. One benefit of their approach will be that by mid-October all of the investments (other than the Gilts) will have been replenished by the In-house team.

1.4.11 Following the transfer, initial core fund maturities have been reinvested in nine month term deposits (both fixed and tradable certificates of deposit) to generate yield. Other maturities as they arise will be invested in shorter duration instruments (mix of three and six month durations) to retain a degree of liquidity and take advantage of interest rate rises should they occur. Although its 'early days' the table at paragraph 1.4.5 demonstrates an improvement in core fund yield during August. The improvement in yield will continue as the months pass such that interest earned on core funds is expected to be in-line with budget for the final eight months of the financial year.

1.4.12 To accommodate the transfer the number of counterparties on our lending list **[Annex 2]** was expanded and investment limits attributable to cash flow and core fund activities separately identified. The two funds, whilst managed by the same staff, are treated as separate identities. The approach has ensured the simplicity of our daily cash flow management and associated staff cover arrangements can be perpetuated. The expanded lending list will help ensure the diversity of the combined portfolios can be maintained in the future.

1.5 Borrowing

1.5.1 It is a statutory duty for the Council to determine and keep under review the 'Affordable Borrowing Limits' by way of the Prudential Indicators (affordability limits) set out in the approved 2014/15 Investment Strategy. The Authority is debt free and uses a combination of reserves and revenue contributions to finance the Capital Plan. Borrowing on a temporary basis using overdraft facilities may be required from time to time to meet liquidity needs. No borrowing was undertaken in the period April 2014 to August 2014.

1.6 Compliance with the Annual Investment Strategy

1.6.1 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the 2014/15 Investment Strategy and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found at **[Annex 4]** to this report.

1.6.2 Throughout April to August 2014 all of the requirements contained in the 2014/15 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.

1.7 Review of risk parameters

1.7.1 Members will recall the detailed consideration that was given to the 2014/15 Annual Investment Strategy at the January 2014 meeting of the Audit Committee. The strategy includes the detailed parameters that aim to limit the Council's exposure to investment risks by requiring investments to be placed with highly credit rated institutions and that those investments are diversified across a range of counterparties. More specifically the 2014/15 Investment Strategy requires:

- Counterparties must be regulated by a Sovereign rated AA- or better as recognised by each of the three main rating agencies (Fitch, Moody's or Standard & Poor's).
- Whilst 100% of funds can be invested in the UK, exposure to non-UK banks is limited to no more than 20% of funds per Sovereign.
- Exposure to individual counterparties / groups of related counterparty must not exceed 20% of funds (25% of funds for part state owned UK Banks).
- In selecting suitable counterparties the Council has adopted Capita'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, 12 months, 5 years etc.). At the time of placing an investment the financial institution must be assigned a durational band of at least 100 days. This broadly equates to a minimum long term credit rating of Fitch A (high) and a short term credit rating of Fitch F1 (strong).
- The duration of an investment in a foreign bank must not exceed Capita's recommendation. For UK financial institutions Capita's duration recommendation can be enhanced by up to three months subject to the combined duration (Capita recommendation plus the enhancement) not exceeding 12 months.
- Money Market funds should be rated Fitch AAAmmf or equivalent and exposure limited to no more that 20% per fund.
- Enhanced Money Funds should be rated AAA and exposure limited to no more than 10% per fund and 20% to all such funds.

1.7.2 The 2014/15 Strategy also limits the type of instrument (e.g. term deposits, floating rate notes etc.) that can be used and establishes a maximum investment duration (2 years other than Gilts). Given our overriding investment priorities of security of capital and liquidity the Council does not invest in equities.

1.7.3 In preparing this report our risk parameters have been reviewed and no changes are proposed.

1.8 Money market fund regulatory changes

1.8.1 Money market funds (MMFs) form a critical component in our daily cash flow management. They provide the same day access to cash as a traditional bank deposit account; allow surplus cash to be placed in a AAA credit rated product; and ensure our peak monthly cash balances are disbursed across a range of counterparties. The current yield on a typical fund used by the Council is 0.4%

and falls roughly mid-way between the average yield from our bank deposit accounts at 0.6% and that offered by the UK Debt Management Office at 0.25%.

1.8.2 Regulatory changes affecting funds traded in the US have recently been introduced by the Securities and Exchange Commission. Whilst these regulations do not affect funds domiciled in Europe (the ones we use) regulatory reform in Europe is in progress. The exact nature of the reform and when it will be enacted is unclear at the present time. Any change, however, will involve a 'bedding-in period' to allow MMFs to adapt to the new requirements. Any impact on our cash management operation is unlikely before next financial year.

1.9 Credit rating agencies approach to sovereign support for banks

1.9.1 The main rating agencies (Fitch, Moody's and Standard & Poor's) have historically provided some institutions with an uplift to their credit ratings to reflect sovereign support. Due to the evolving regulatory regime, these support levels are going to be removed by the rating agencies and this process may commence as early as this calendar year. The actual timing of the changes is still subject to discussion but it has already prompted a change in the way Capita assesses creditworthiness.

1.9.2 It is important to stress that the change in approach by the rating agencies does not reflect a change in the underlying status of an institution or the credit environment in which they operate, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of Government support will only take place when the regulatory environment has ensured that financial institutions are much stronger and less prone to failure in a crisis should one occur in the future.

1.9.3 Both Fitch and Moody's provide 'standalone' credit ratings for financial institutions. For Fitch, it is the viability rating, while Moody's has the financial strength rating. Due to the removal of sovereign support from institution assessments, both agencies have suggested that in the future these will be the same as their long term ratings. As a result, Capita see no merit in monitoring both long term and 'standalone' ratings.

1.9.4 Furthermore, Fitch has already begun reassessing its support ratings, with a clear expectation that these will be lowered to 5, which is defined as 'A bank for which there is a possibility of external support, but it cannot be relied upon.' With all institutions likely to drop to these levels, Capita see little to no differentiation to be had from continuing to include support ratings in their methodology.

1.9.5 As a result of these rating agency changes, the credit element of Capita's methodology now focus solely on the short and long term ratings of an institution. Rating watch and outlook information continues to feature in Capita's assessment where it relates to these categories as does the use of credit default swap data. The change in Capita's methodology was introduced in June of this year and had little impact on their credit worthiness assessments (no banks were removed from

the list of suggested counterparties, a few were added and a few had their recommended investment duration increased by one band).

1.9.6 Credit ratings play a key role in our approach to risk management. Whilst the changes outlined above are unlikely to impact on the number of counterparties on our internal lending list during the remainder of this financial year this is an issue we will need to revisit when we consider the Annual Investment Strategy for 2015/16.

1.10 Legal Implications

1.10.1 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.

1.10.2 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

1.11 Financial and Value for Money Considerations

1.11.1 The Bank Rate has remained at a historic low of 0.5% for over 5 years. Capita, our treasury advisors, in common with other market forecasts, anticipate an interest rate rise sometime during the final months of the current 2014/15 financial year.

1.11.2 Investment income is £9,400 below budget at the end of August. The shortfall is attributed to the relatively poor performance achieved by our external fund manager in the early part of the year. Core funds were transferred to In-house management at the beginning of August and investment income for the remainder of the financial year is expected to be broadly in-line with budget.

1.11.3 Investment performance is monitored against relevant benchmarks and compared to other local authorities using benchmarking data provided by Capita.

1.12 Risk Assessment

1.12.1 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 the most effective way of mitigating the risks associated with treasury management.

1.13 Equality Impact Assessment

1.13.1 See 'Screening for equality impacts' table at the end of this report.

1.14 Recommendations

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

1) Endorse the action taken by officers in respect of treasury management activity for the period April to August 2014.

2) Note the transfer of responsibility for core fund investments to In-house management took effect on 1 August 2014.

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

Background papers: contact: Mike Withey

Nil

Sharon Shelton
Director of Finance & Transformation

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
a. Does the decision being made or recommended through this paper have potential to cause adverse impact or discriminate against different groups in the community?	No	N/A
b. Does the decision being made or recommended through this paper make a positive contribution to promoting equality?	No	N/A
c. What steps are you taking to mitigate, reduce, avoid or minimise the impacts identified above?		N/A