TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

25 July 2022

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2021/22

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 2021/22 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 implementing best practice in accordance with CIPFA's revised Code of Practice.

1.2 Economic Background

1.2.1 The annual inflation rate (CPI) rose from 9.0% in April to a new 40-year high of 9.1% in May and it is not yet close to its peak. The increase in CPI inflation in May was mainly due to a further leap in food price inflation from 6.7% to a 13-year high of 8.5%. With the influence of increases in agricultural commodity prices yet to fully feed into the prices on the supermarket shelves, food price inflation is expected to rise above 10% in September. Utility prices are expected to rise by a further 40% in October driving CPI inflation to peak at around 10.5%.

1.2.2 There is currently little evidence that higher inflation and higher interest rates have become a big drag on activity albeit services output has dropped by 0.3%, consumer-facing services, conversely, rose by 2.3% in April.

1.2.3 The MPC has now increased interest rates five times in as many meetings and raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed raised rates by 75 basis points (bps) in June and a handful of other central banks have recently raised rates by 50bps, the Bank of England’s action is relatively dovish. The MPC’s decision not to follow the Fed and raise rates by more makes some sense considering the UK’s status as a larger importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.

1.2.4 The MPC's new guidance is that if there are signs of "more persistent inflationary pressures" it will, "if necessary, act forcefully in response". The expectation is for the MPC to continue to raise rates in steps of 25bps rather than 50bps. The Councils appointed treasury advisors, Link Group, have formulated a view that the MPC will continue to raise rates from the current 1.25% to a peak of 2.75% next year. That is higher than the peak of 2.00% forecast by economists, but lower than the peak being priced into the financial markets.

1.3 Interest Rate Forecast

1.3.1 Since Q3 2021 there has been a series of 0.25% bank rate increases. The Link Group's latest interest rate forecast below has been revised to reflect the further increases in the Bank Rate as inflation is now posing a greater risk. To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation (as measured by wage rises) under control, but without pushing the economy into recession. Link's forecast was updated following the MPC meeting on 15 June 2022, assumes Bank Rate will continue to increase and peak at 2.75% before gradually reducing over the next two years.

Link - June 2022	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	1.75	2.25	2.75	2.75	2.75	2.75	2.50	2.50	2.25	2.25	2.25
3 mth ave earnings	2.00	2.50	2.80	2.80	2.80	2.80	2.60	2.50	2.30	2.30	2.20
6 mth ave earnings	2.50	2.80	3.00	3.00	2.90	2.90	2.80	2.70	2.60	2.50	2.40
12 mth ave earnings	3.10	3.20	3.20	3.20	3.00	2.90	2.80	2.60	2.50	2.40	2.40
25yr PWLB	3.70	3.70	3.70	3.70	3.70	3.70	3.60	3.50	3.50	3.40	3.40

Table 1

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 2022/23 cash flow surpluses have averaged £31m per day.

1.4.4 The Authority also has £18m of core cash balances. These funds are for the most part available to invest for more than one year, albeit a proportion is usually transferred to cash flow towards the end of the financial year to top-up daily cash balances. Core cash includes the Council's capital and revenue reserves which are being consumed over time to meet capital expenditure and 'buy time' to enable the authority to deliver its revenue savings targets.

1.4.5 Cash flow and core cash balances also include sums to meet business rate appeals which are expected to be resolved in 2022/23 and future years.

1.4.6 Long term investments at the end of June 2022 comprised £5m in property fund investments.

1.4.7 Medium term investments at the end of June 2022 comprised £4.25m in multi-asset diversified income funds.

1.4.8 A full list of investments held on 30 June 2022 is provided at **[Annex 1]** and a copy of our lending list of 27 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 2022 £m	Average duration to maturity Days	Weighted average rate of return %	Interest / dividends earned 1 April to 30 June 2022 £	Gross annualised return %	SONIA benchmark (average) 1 April to 30 June 2022 %
Cash flow	30.8	4	1.13	65,850	0.86	0.99
Core cash	18.0	106	1.20	47,650	0.93	1.22
Sub-total	**48.8**	**41**	**1.16**	**113,500**	**0.92**	**1.19**
Long term	5.00			43,650	3.49	
Medium term	4.25			53,950	5.08	
Total	**58.05**			**211,100**	**1.33**	

Table 2

1.4.9 **Cash flow and Core cash Investments**. Whilst the authority performed lower than the SONIA benchmark, it is important to acknowledge core deals which have been previously locked in when rates were low and will mature in year providing the opportunity to reinvest at a more attractive level. Interest earned of £113,500 to the end of June is £96,540 higher than the original estimate for the same period. The increase in income reflects the quick succession of interest rate rises from December 2021 and the favourable rates that are currently offered by the markets.

1.4.10 Bank offers are expected to continue to rise throughout 2022/23. As a result of the recent increases in the bank rate, cash flow and core cash investment income is projected to outperform the original budget by circa £350,000. The improved level of expected investment income will be reflected in the revised estimates.

1.4.11 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 2022 the Council's return at 0.50% (purple diamond) was in line with the local authority average of 0.49%. Based on the Council's exposure to credit / duration risk that return was in-line with Link's predicted return (between the upper and lower boundary indicated by the diagonal lines). The Council's risk exposure was also consistent with the local authority average.

1.4.12 **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.

1.4.13 £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 where resources become available from asset disposals and other windfalls.

1.4.14 During the period 1 April 2022 to 30 June 2022 the £5m investment in property funds generated income from dividends of £43,670 which represents an annualised return of 3.49%. Income is in line with the budget to the end of June.

1.4.15 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 or redemption of units avoided.

1.4.16 Current sale value (May 2022 data) 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 2022 C £	30 June 22 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	1,152,700	152,700
Lothbury (Primary, July 2017)	1,000,000	927,700	1,090,400	90,400
Hermes (Secondary, Oct 2017)	1,000,000	939,000	1,181,800	181,800
LAPF (Primary, June 2018)	1,000,000	922,200	1,105,200	105,200
Lothbury (Secondary, July 2018)	1,000,000	973,000	1,069,400	69,400
Total change in principal	5,000,000	4,684,100	5,599,500	**599,500**
			Total dividends received to June 2022	**783,700**
Table 3			**Net benefit since inception**	**1,383,200**

1.4.17 Since inception, the Council has received dividends from its property fund investments totalling £783,700. The property markets have proved to be very resilient over the past 12 months providing capital growth on the portfolio of circa 11%. There are no current indicators that the market will contract in the short term.

1.4.18 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.

1.4.19 **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.

1.4.20 A total of £3m was initially invested equally across three funds in July and August, with a further £1.25m invested in November 2021 across two of the funds with the proceeds from the sale of River Walk. Additional multi asset fund investments could be made in the future where resources become available from asset disposals and other windfalls.

1.4.21 During the period 1 April 2022 to 30 June 2022 the £4.25m investment in multi asset diversified income funds generated income from dividends of £53,930 which represents an annualised return of 5.08%. Income has performed some £14,000 above budget to the end of June.

1.4.22 Since inception the Council has received dividends of £149,800 from its multi-asset diversified income funds, which represents an annualised return of 4.2%

1.4.23 As at 30 June, the value of multi asset diversified income funds at 30 June stood at £3.763m compared to the initial capital investment of £4.250m. Capital values are expected to recover over the medium term.

1.5 Compliance with the Annual Investment Strategy

1.5.1 Throughout April to June 2022, all the requirements contained in the 2022/23 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 2022.

1.5.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The 2022/23 Prudential and Treasury Indicators will be included for review as part of the treasury management report to the September 2022 meeting of Audit Committee.

1.6 2021/22 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 7 June 2022 as an annex to the Revenue and Capital Outturn report for 2021/22. 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.

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

	2021/22 Average balance £m	Return %	2021/22 Interest/ dividends earned £	2021/22 Revised Estimate £	Variance Better (worse) £
Cash flow surpluses	22.3	0.14	30,581	9,200	21,381
Core cash	20.3	0.34	69,874	55,000	14,874
Medium term investment	4.3	3.87	95,869	61,900	33,969
Long term investment	5	3.17	158,725	170,000	-11,275
Total	51.9	0.82	355,049	296,100	58,949

Table 4

1.6.3 The combined performance of the Authority's investments exceeded the revised estimate by £58,949, and £105,049 when compared to the 2021/22 original estimates. The increase in investment returns is due to the interest rate changes applied in December 2021 through to March 2022.

1.6.4 Income and expenditure attributed to the Treasury Management function for 2021/22 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.

1.7 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 Due to the pressures of inflation driven by a number of issues including supply and labour market shortages, the BoE pursued a proactive approach in tackling rising inflation by raising Bank Rate five times since December 2021 bringing the current rate to 1.25%. Link's current forecast (updated June 2022) anticipates Bank Rate increasing to 2.75% over the next two years.

1.8.2 Investment income at the end of June 2022 (month three of the financial year) from cash flow surpluses and core cash investments is a favourable variance of £96,540 to the budget for the same period. Income from property funds at the end of June is in line with the budget and diversified income funds are exceeding the budget by some £14,000 for the same period. Investment income for the financial year as a whole from these sources is expected to outperform the original budget by some £350,000.

1.8.3 Performance is monitored against a benchmark return and against other local authorities in Kent and the broader local authority pool via Link's benchmarking service.

1.8.4 Whilst the annual income stream from a property fund exhibits stability (circa 3-4% per annum net of management fees) capital values rise and fall with the cyclical nature of economic activity. During a downturn in the economy capital values may fall significantly. The duration of a property fund investment may need to be extended to avoid crystalizing a loss and as a consequence, the investment's duration cannot be determined with certainty.

1.8.5 Buying and selling property involves significant costs making property unsuitable for short term investment. Buying and selling costs are reflected in the entry fees (circa 6%) and exit fees (circa 2%) a property fund will charge unit holders. These fees are expected to be recouped overtime through capital appreciation.

1.8.6 The money being applied to property fund investment from existing resources is expected to be available in perpetuity. Nevertheless, the Council's cash balances will continue to be monitored and due regard had to the potential for a fund to delay payment of redemption requests by up to twelve months. Funds will seek to minimise their own cash balances in favour of holding property and therefore manage redemption requests for the benefit of all fund participants. The Council is only likely to seek redemption to pursue a higher yielding income opportunity should one be identified.

1.8.7 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 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 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 Council:

1) Endorse the action taken by officers in respect of treasury management activity for April to June 2022.

2) Note the 2021/22 outturn position.

Background papers: contact: Donna Riley

Link interest rate forecast (June 2022)
Link benchmarking data (March 2022)

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