

TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

26 September 2022

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 2022/23 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 and in December 2021 CIPFA published updates to the Treasury Management Code. The requirements of the Code have been taken into account in the mid-year review.

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 2022/23 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2022/23.
- A review of the risk parameters contained in the 2022/23 Treasury Management and Annual Investment Strategy.

1.2 Economic Background

1.2.1 As expected, the Bank of England's Monetary Policy Committee (MPC) voted by an 8-1 majority to increase Bank Rate by 0.50 percentage points to 1.75% at its August meeting, pushing borrowing costs to their highest in 13 years as the MPC tries to temper soaring inflation. The central bank now expects inflation to reach over 13% in Q4 2022 and to remain at very elevated levels throughout much of 2023. The Bank's forecasts were adjusted to reflect:

- The Bank acknowledged that GDP growth is slowing citing the latest rise in gas prices has led to another significant deterioration in the outlook for activity in the UK and the rest of Europe. The UK is now projected to enter recession from the fourth quarter of this year.
- The BoE revised its growth forecast downwards for the foreseeable future. GDP growth is expected to fall for Q3 2022 to 2.3% from 2.9% previously forecast. Subsequent forecasts were also revised down to -2.1% y/y for Q3 2023 from -0.8% y/y.
- The annual inflation rate in the UK increased to 10.1% y/y in July from 9.4% in June, slightly above market forecasts of 9.8%. The result represented the highest reading since February 1982, as prices rose faster for housing & utilities (20.0% y/y), food & non-alcoholic beverages (12.6%) and restaurant & hotels (8.9%). Transportation prices also rose 14.8%, although this was less than June's 14.9% y/y rise. Compared to the previous month, consumer prices rose 0.6%, below 0.8% in June, but above forecasts of 0.4%.
- The unemployment rate was at 3.8% in Q2, unchanged from the previous three month period (January to March) but is 0.2% below pre-coronavirus pandemic levels.

1.2.2 Central forecast for interest rates was previously updated on 21 June and reflected a view that the MPC will be keen to further demonstrate its anti-inflation credentials by delivering a succession of rate increases, including in August. It is expected that a further 0.5% increase in September; another 0.25% increase in November and a further 0.25% hike in February. The timing and size of the interest rate rises will be data dependent and, potentially, influenced by the actions of the US FOMC (Federal Open Market Committee) and also the policies of the new Prime Minister, Liz Truss.

- 1.2.3 Due to recent events there has been some delays in receiving data including any fiscal policy change which may have implication on the Economic outlook. Any relevant updates will be provided in due course.

1.3 Interest Rate Forecast

- 1.3.1 Link's forecast used in the 2022/23 Investment Strategy which was approved as part of the budget setting process assumed economic conditions would continue to improve and resulting in a gradual rise in Bank Rate over the next three years.

Link - Dec 2021	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00
3 mth ave earnings	0.20	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00
6 mth ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10
12 mth ave earnings	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20
25yr PWLB	1.80	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40

Table 1 (a)

- 1.3.2 Since the approval of the 2022/23 Investment Strategy the conflict in Ukraine and the subsequent impact on the global economic conditions, e.g. soaring inflation has resulted in the MPC announcing a series of 0.25% and 0.50% bank rate increases and is expected to continue over the short term.
- 1.3.3 Due to more recent events and the ever changing market sentiment, the interest rate forecast provided by The Link Group has been postponed until the rescheduled MPC meeting has taken place on Thursday 22 September. This will enable Link to incorporate the latest decisions taken by the MPC into an updated interest rate forecast for distribution.

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 2022/23 cash flow surpluses have averaged £25.77m.

- 1.4.4 The Authority also has £28m 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 2022/23 and the remainder in future years.
- 1.4.6 Long term investment at the end of August 2022 comprised £5m in property fund investments.
- 1.4.7 Medium term investments at the end of August 2022 comprised £4.25m in multi asset fund investments.
- 1.4.8 A full list of investments held on 31 August 2022 is provided at **[Annex 1]** and a copy of our lending list of 31 August 2022 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 2022	Average duration to maturity	Weighted average rate of return	Interest / dividends earned	Gross annualised return	SONIA benchmark (average)
	£m	Days	%	1 April to 31 August 2022	%	1 April to 31 August 2022
				£		%
Cash flow	25.77	8	1.70	122,500	0.95	n/a
Core cash	28.00	109	1.78	114,400	1.42	n/a
Sub-total	53.77	61	1.74	236,900	1.13	n/a
Long term	5.00			43,700	3.49	
Medium term	4.25			91,300	5.16	
Total	63.02			371,900	1.96	

Table 2

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2022.

- 1.4.9 **Cash flow and Core cash Investments.** Interest earned of £236,900 to the end of August is higher than the original estimate for the same period. The increase in investment income reflects the quick succession of interest rate rises from December 2021 and provided an opportunity to reinvest surplus cash at a more

favourable rate. Due to current events SONIA data has not been made available for comparison. However the benchmarking data below provides an insight to the investment performance against Local Authorities of a similar size.

- 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 upward of £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. As at 30 June 2022 the Council's return at 1.07% (purple diamond) was above the local authority benchmark group average of 0.97%, Link's predicted return is between the upper and lower boundary indicated by the diagonal lines. The Council's risk exposure was consistent with the local authority average.
- 1.4.12 **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 as 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 dividends of £43,700 which represents an annualised return of 3.49% (3.23% in 2021/22). The property funds have proved to be very resilient over the past 12 months 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 2022/23.
- 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 / redemption of units avoided.

1.4.16 Current sale values vs initial purchase price are as follows:

Property fund (Primary = units in the fund purchased from the fund manager. Secondary = units purchased from another investor at a discount. Date = first month the investment attracted dividends)	Purchase price	Sale value at date of purchase	Sale value 30 June 2022	30 June 22 sale value above (below) purchase price (c-a) £
	a	b	C	
	£	£	£	
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
Net benefit since inception				1,383,200

Table 3

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 12%. 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, 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.

1.4.19 **Medium term Investment.** In recent years multi asset (diversified income) funds have grown in popularity. The rationale 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 multi-asset (diversified income) funds into the Annual Investment Strategy.

1.4.20 Like property funds, multi asset (diversified income) funds aim to generate returns over and above inflation and thus preserve spending power.

- 1.4.21 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.
- 1.4.22 During the period 1 April 2022 to 31 August 2022 the £4.25m investment in multi asset (diversified income) funds generated income from dividends of £91,300 which represents an annualised return of 5.16%. Income has performed some £25,800 above budget to the end of August.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

- 1.5.1 Throughout the period April to August 2022 all of 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 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 2022.
- 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 2022/23 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, we will continue to look 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. 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 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 six times since December 2021 bringing the current rate to 1.75%.

1.8.2 Due to recent events Link will produce an updated Bank Rate forecast after the next MPC meeting scheduled to take place on Thursday 22 September. Further details on the anticipated Bank Rate increases will be provided in due course.

1.8.3 Investment income at the end of August 2022 (month five of the financial year) from cash flow surpluses and core cash investments is a favourable variance of £208,600 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 £25,800 for the same period. Investment income for the financial year as a whole from these sources is expected to outperform the original budget by upward of £350,000.

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 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.

1.8.6 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 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.

- 1.8.8 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 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 2022.
- 2) Retain the existing parameters intended to limit the Council's exposure to investment risks.

Background papers:

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Link benchmarking data (June 2022)

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