TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

16 January 2023

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 2023/24

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 2023/24 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 Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, the UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022. Link's forecast used in the 2022/23 Investment Strategy assumed economic conditions would steadily climb, reaching 1.25% over the next three years.

1.2.2 Since the approval of the 2022/23 Strategy was published last February the conflict in Ukraine and the subsequent impact on the global economic conditions has contributed towards soaring inflation. The MPC has acted to bring inflation under control by way of increasing the interest rates several times in as many meetings. Although we are expecting to see interest rate continue to rise in the coming months, it is expected to peak at 4.5% compared to the previously forecasted rate of between 5% - 6%.

1.2.3 CPI inflation peaked at 11.1% in October and although it remains elevated, it is expected to come down. However, this does not take into account the further increases in the gas and electricity price caps pencilled in for April 2023, and the cap potentially rising from an average of £2,500 to £3,000 per household so there is still a possibility that inflation will spike higher again before dropping back slowly through 2023.

1.2.4 UK unemployment rate is at a 48-year low of 3.6%, and this despite a net migration increase of circa 500k. The fact is that with many economic participants registered as long-term sick, the UK labour force has shrunk by circa 500k in the year to June. Without an increase in the labour force participation rate, it will be difficult for the UK economy to grow its way to prosperity. Average wage increases are running at over 6% is likely to give the MPC concern that wage inflation will prove just as difficult to manage as the major supply-side shocks to food and energy that have endured since Russia’s invasion of Ukraine.

1.2.5 Link’s latest Bank Rate forecast, updated in December 2022, is included in **[Annex 5]** and anticipates the Bank Rate peaking at 4.50% in 2023/24 before reducing to 2.50% by March 2026.

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 2022/23 cash flow surpluses have averaged £22.4m.

1.3.3 The Authority also has £30m 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 2022/23 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 30 November 2022 is provided at **[Annex 1]** and a copy of our lending list of 28 November 2022 is provided at **[Annex 2]**. The table below provides a summary of funds invested and income earned at the end of November.

	Funds invested on 30 November 2022 £m	Average duration to maturity Days	Weighted average rate of return %	SONIA benchmark (average) 1 April to 30 November 2022 %	Interest / dividends earned 1 April to 30 November 2022 £	Gross annualised return %
Cash flow	31.91	7	1.31	1.55	277,590	2.92
Core cash	30.00	121	1.81	2.11	288,360	3.03
Sub-total	**61.91**	**62**	**1.52**	**1.79**	**565,950**	**2.97**
Long term	5.00				86,200	3.45
Medium term	4.25				126,600	4.47
Total	**71.16**				**778,750**	**3.63**

Table 1

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

1.3.8 **Cash flow and core cash investments**. Whilst the SONIA benchmark exceeds the authority's performance it should be noted where we are in relation to the investment cycle. SONIA is forward looking versus the authority figures which are based on interest earned to date. The result of which shows the authority is at the point in the cycle where we are behind the curve. However, once Bank Rates stabilise and start to come down, it is expected that we will remain ahead of the curve for longer. At this point our figures will show an outperformance of the benchmark. The benchmarking data provided in Annex 3 shows the authority's performance is above average when compared to other authorities of similar size.

1.3.9 Interest earned of £565,950 to the end of November is £520,700 above the original budget estimate for the same period. The increases in Bank Rates have been taken into consideration and updated figures have been included in the revised budget.

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 2022 the Council's return at 2.07% (purple diamond) was above 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 2022/23.

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 2022 to 30 September 2022 the £5m investment in property funds generated dividends of £86,200 which represents an annualised return of 3.4% (3.1% in 2021/22). 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 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 2022 C £	30 November 22 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	967,700	(32,300)
Lothbury (Primary, July 2017)	1,000,000	927,700	875,000	(125,000)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	974,800	(25,200)
LAPF (Primary, June 2018)	1,000,000	922,200	927,900	(72,100)
Lothbury (Secondary, July 2018)	1,000,000	973,000	858,200	(141,800)
Total change in principal	5,000,000	4,684,100	4,603,600	**(396,400)**
			Total dividends received to September 2022	**827,300**
Table 2			**Net benefit since inception**	**430,900**

1.3.17 Since inception, the Council has received dividends from its property fund investments totalling £827,300. It was previously reported that there were no indicators that the market would contract in the short term. Since then there has been a decline in the capital value of the property funds against the original purchase price as we entered a recession. The property funds continue to distribute dividends of which we have received £86,200 for the first six months of the year.

1.3.18 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.

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

1.3.20 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".

1.3.21 A total of £4.25m was invested in 2021/22 between three funds chosen from the rigorous selection process, Fidelity Multi Asset Income Fund, Ninety-One Diversified Income Fund and Aegon Diversified Monthly Income Fund. It is expected that each fund will deliver a return in excess of 3% per annum and preserve capital over the five-year duration of the investment. Funds invested included 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.

1.3.22 During the period April 2022 to November 2022 the £4.25m investment in multi asset funds generated dividends of £126,600 which represents an annualised return of 4.47%.

1.3.23 **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. Expenditure is expected to rise in-line with inflation.

1.4 Annual Investment Strategy for 2023/24

1.4.1 The Council's treasury advisor anticipates bank rate rising next year and holding for three quarters before falling back to 2.50% over the next three years 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 close the current financial year at 4.25% seeing two further rate rises in the final quarter of 2022/23.

1.4.2 The UK unemployment rate fell to a 48-year low of 3.6% and without an increase in the labour force participation rate, it is difficult to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food and energy that have endured since Russia's invasion of Ukraine.

1.4.3 Globally, all the major economies are expected to struggle in the near term. The fall below 50 in the composite Purchasing Manager Indices for the UK, US, EZ and China all point to at least one, if not more, quarters of GDP contraction. In November, the MPC projected eight quarters of negative growth for the UK lasting throughout 2023 and 2024, but with Bank Rate set to peak at lower levels than previously priced in by the markets and the fiscal tightening deferred to some extent, it is not clear that things will be as bad as first anticipated by the Bank.

1.4.4 The returns on our **property fund investments**, though representing only 7.03% of 2022/23 investment portfolio, are likely to generate some 12.3% 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.

1.4.5 The returns on our **diversified income fund investments**, though representing only 5.97% of 2022/23 investment portfolio, are likely to generate some 10.4% 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.

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

1.4.7 The changes to the 2023/24 strategy include the new Liability Benchmark **[Annex 5, Appendix 2]** and the exclusion of the UK Sovereign Rating, **[Annex 5, 10.1]** which will be revisited at the Mid-Year Review. 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.

1.4.8 **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 2023/24 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 normally subject to the UK sovereign being rated A- or higher by each of the three main rating agencies. However the UK Sovereign debt rating has been placed on Negative Outlook by the three major rating agencies and it is possible the UK Sovereign debt rating will be downgraded. Accordingly, when setting minimum sovereign debt ratings, this Authority will not set a minimum rating for the UK and to be revisited at the Mid-Year Review. The UK currently receives a rating of AA- from Fitch, AA3 from 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 2029/30, 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.

1.4.9 The 2023/24 Strategy **[Annex 5]** reflects the current economic environment, Link Asset Services' latest interest rate forecast and incorporates the risk parameters summarised in paragraph 1.4.8.

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 2029/30. 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 have been taken into account in the 2023/24 Treasury Management and Annual Investment Strategy.

1.7 Financial and Value for Money Considerations

1.7.1 The Bank Rate is currently 3.0%. Link's current forecast (December 2022) anticipates Bank Rate rising to 4.50% by June 2023 and holding for three quarters before falling back to 2.50% over the next three years to March 2026.

1.7.2 Following the interest rates increases over the past several months the investment income at the end of November 2022 (month eight of the financial year) from cash flow surpluses and core cash investments exceeds the original budget for the same period by £520,700. Income from property funds at the end of September is in line with the original budget for the same period. Investment income from multi-asset funds has generated £126,600 of income, and is some £22,000 in excess of the original budget. Investment income for the year as a whole is expected to exceed the original budget by circa £560,000.

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 2023/24 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 2022.

2) Adopts the Treasury Management and Annual Investment Strategy for 2023/24 set out at **[Annex 5)**.

Background papers: contact: Donna Riley

Link Asset Services: Interest rate forecast (December 2022), economic commentary and benchmarking data.

Sharon Shelton
Director of Finance and Transformation