TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

24 July 2023

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2022/23

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 2022/23 is also included in this report.

1.1 Introduction

1.1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management 2021 recommends that members be updated on treasury management activities at least quarterly. This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

1.1.2 Following the Treasury Management training provided to Members in June 2023 the Chairman expressed an interest to invite our externally managed funds to present to the Committee.

1.1.3 Kelly Watson, Head of Local Government Relationships from CCLA will be in attendance **at the beginning of the meeting** to present the LAPF Portfolio which will include the fund performance and the sustainable investment outcomes.

1.2 Economic Background

1.2.1 CPI inflation remained at 8.7% in May (consensus 8.4%), however core CPI inflation, which excludes volatile goods and services such as the food and fuel prices, rose again from 6.8% to a new 31-year high of 7.1% The rise in core inflation built on the leap from 6.2% in March to 6.8% and means it is accelerating in the UK while it is slowing in the US and the Euro-zone (both fell to 5.3%). A further decline in fuel inflation, from -8.9% to -13.1%, and the second fall in food inflation in as many months, from 19.3% to 18.7%, provide an explanation to why overall CPI inflation didn’t rise.

1.2.2 The scheduled fall in the average annual utility price from £2,500 to £2,074 on 1st July means overall CPI inflation will probably ease in the coming months. However with the recent surge in core inflation and the reacceleration in wage growth shows that domestic inflationary pressures are still strengthening.

1.2.3 This suggests the Bank may have more work to do than the Fed or ECB. Indeed, the Bank of England sounded somewhat hawkish in the June meeting. This came through most in the MPC's decision to step up the pace of hiking from the 25bps at the previous two meetings. The 7-2 vote, with only two members voting to leave rates unchanged at 4.50%, revealed support for stepping up the fight against high inflation.

1.2.4 The Bank has not committed to raising rates again or suggested that 50bps rises are now the norm. What it did say was that "the scale of the recent upside surprises in official estimates of wage growth and services CPI inflation suggested a 0.5 percentage point increase in interest rates was required at this particular meeting". Moreover, the MPC did not strengthen its forward guidance that any further rate hikes would be conditional on the data.

1.2.5 It looks highly probable, given the on-going strength of inflation and employment data, that the Bank will need to raise rates to at least 5.5% and to keep rates at their peak until the mid-point of 2024. The consensus is it is only a matter of time before the rise in rates weakens the economy sufficiently to push it into recession.

1.2.6 The markets have currently priced in rises to between 6.00%-6.25%, however the Councils appointed treasury advisors, Link Group, have formulated a view that the rates will more likely peak between 5.50-6.00%. The forecast is also for rates to be cut in the second half of 2024, and rates are expected to fall further than markets are currently pricing in.

1.3 Interest Rate Forecast

1.3.1 The Link Group's latest interest rate forecast below has been revised to reflect the further increases in the Bank Rate to dampen inflation. The latest forecast sets out a view that both short and long-dated interest rates will be elevated for some while, as the Bank of England seeks to squeeze inflation out of the economy, against a backdrop of a stubbornly robust economy and a tight labour market. Link's forecast was updated following the MPC meeting on 22 June 2023, assumes Bank Rate will continue to increase and peak at 5.50% before gradually reducing over the next two years.

Link - June 2023	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26
	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	5.50	5.50	5.50	5.25	4.75	4.25	3.75	3.25	2.75	2.75	2.50
3 mth ave earnings	5.60	5.50	5.30	5.00	4.50	4.00	3.50	3.00	2.70	2.60	2.50
6 mth ave earnings	5.90	5.70	5.50	5.10	4.60	4.00	3.50	3.00	2.70	2.60	2.60
12 mth ave earnings	6.20	6.00	5.70	5.30	4.80	4.10	3.60	3.10	2.80	2.70	2.70
25yr PWLB	5.40	5.20	5.10	4.90	4.70	4.50	4.20	4.00	3.90	3.80	3.80

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 2023/24 cash flow surpluses have averaged £26m per day.

1.4.4 The Authority also has £24m 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 2023/24 and future years.

1.4.6 Long term investments at the end of June 2023 comprised £5m in property fund investments.

1.4.7 Medium term investments at the end of June 2023 comprised £4.25m in multi-asset diversified income funds.

1.4.8 A full list of investments held on 30 June 2023 is provided at **[Annex 1]** and a copy of our lending list of 30 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 2023 £m	Average duration to maturity Days	Weighted average rate of return %	SONIA benchmark (average) 1 April to 30 June 2023 %	Interest / dividends earned 1 April to 30 June 2023 £	Gross annualised return %
Cash flow	26.32	8	4.84	4.72	308,685	5.43
Core cash	24.00	66	4.50	4.97	290,093	4.47
Sub-total	**50.32**	**36**	**4.62**	**4.93**	**598,778**	**4.68**
Long term	5.00				45,350	3.63
Medium term	4.25				54,352	5.12
Total	**59.57**				**698,480**	**4.35**

Table 2

1.4.9 **Cash flow and Core cash Investments**. The SONIA benchmark remains on an upward trajectory due to the increasing rates from the Bank of England's MPC. Due to the longevity of some of the core investments made during 2022/23 the invested interest rates are below this level. Therefore, this is having an offsetting effect on the positive cashflow returns.

1.4.10 Interest earned of £598,778 to the end of June is £317,530 higher than the original estimate for the same period. The increase in income reflects the continued upward movement of interest rate rises and the favourable rates that are currently offered by the markets.

1.4.11 Bank offers are expected to continue to increase throughout 2023/24 if MPC rates continue to rise. As a result, cash flow and core cash investment income will outperform the original budget. Further analysis will be carried out over the summer to refine the projections and the revised level of treasury investment income will be reported to members at a later date.

1.4.12 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 2023 the Council's return at 4.29% (purple diamond) was above the local authority average of 3.68%. 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.

1.4.13 **Long-term Investment**. £5m of the Council's expected longer term (10 years) cash balances has been invested in three externally managed property funds. These investments provide a stable annual income to meet the Council needs and provide capital growth over time.

1.4.14 Additional property fund investments could be made in the future where resources become available from asset disposals and other windfalls.

1.4.15 During the period 1 April 2023 to 30 June 2023 the £5m investment in property funds generated income from dividends of £45,350 which represents an annualised return of 3.63%. Income is in line with the budget to the end of June.

1.4.16 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.

1.4.17 Current sale value (June 2023 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 2023 C £	30 June 23 sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	914,400	(85,600)
Lothbury (Primary, July 2017)	1,000,000	927,700	806,300	(193,700)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	951,300	(48,700)
LAPF (Primary, June 2018)	1,000,000	922,200	876,800	(123,200)
Lothbury (Secondary, July 2018)	1,000,000	973,000	790,700	(209,300)
Total change in principal	5,000,000	4,684,100	4,339,500	**(660,500)**
			Total dividends received to June 2023	**959,800**
			Net benefit since inception	**299,300**

Table 3

1.4.18 Since inception, the Council has received dividends from its property fund investments totalling £959,800. Commercial property values having momentarily recovered from the impact suffered from Covid-19, has faced new challenges including rising inflation. All property fund investments recorded capital depreciation in the period April 2023 to June 2023.

1.4.19 Lothbury Property Trust is in the process of an internal restructure including an in depth analysis of their property portfolio and their medium to long term strategy. Their new strategy has been presented to Officers and will be shared with relevant Members for further discussions in the coming weeks.

1.4.20 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.

1.4.21 **Medium-term investment**. £4.25m of the Council's expected medium term cash balances together with new money derived from the sale of asset has been invested in externally managed diversified income funds. These investments will generate an annual income stream and will provide capital appreciation over time.

1.4.22 Additional multi asset fund investments could be made in the future where resources become available from asset disposals and other windfalls.

1.4.23 During the period 1 April 2023 to 30 June 2023 the £4.25m investment in multi asset diversified income funds generated income from dividends of £54,352 which represents an annualised return of 5.12%. Income has performed some £16,100 above budget to the end of June.

1.4.24 Since inception the Council has received dividends of £298,350 from its multi-asset diversified income funds, which represents an annualised return of 4.0%

1.4.25 As at 30 June, the value of multi asset diversified income funds stood at £3.655m 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 2023, all the requirements contained in the 2023/24 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 2023.

1.5.2 The Council has also operated within the treasury limits and prudential indicators set out in the Annual Investment Strategy. The 2023/24 Prudential and Treasury

Indicators will be included for review as part of the treasury management report to the September 2023 meeting of Audit Committee.

1.6 2022/23 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the last financial year was submitted to Cabinet on 6 June 2023 as an annex to the Revenue and Capital Outturn report for 2022/23. 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:

	2022/23 Average balance £m	Return %	2022/23 Interest/ dividends earned £	2022/23 Revised Estimate £	Variance Better (worse) £
Cash flow surpluses	32.4	2.29	741,297	218,000	523,297
Core cash	26.0	2.59	676,831	410,900	265,931
Medium term investment	4.3	4.10	174,311	153,000	21,311
Long term investment	5.0	3.44	172,216	170,000	2,216
Total	67.7	2.60	1,764,655	951,900	812,755

Table 4

1.6.3 The combined performance of the Authority's investments exceeded the revised estimate by £812,755, and £1.367m when compared to the 2022/23 original estimates. The increase in investment returns is mainly due to the level and speed at which Bank Rate has risen throughout 2022/23.

1.6.4 Income and expenditure attributed to the Treasury Management function for 2022/23 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

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 continuing domestic pressures of inflation driven by a number of factors including labour market and supply shortages, UK/EU trade arrangements and Geopolitical risks, the BoE continue to increase Bank Rate in an attempt to dampen inflation which remained at 8.7% in May 2023. The current Bank Rate was again increased in June 2023 bring it to 5.0%. Link's current forecast (updated June 2023) anticipates Bank Rate increasing to 5.50% by March 2024 and remaining elevated before steadily reducing to 2.50% by March 26.

1.8.2 Investment income at the end of June 2023 (month three of the financial year) from cash flow surpluses and core cash investments is a favourable variance of £317,530 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 £16,100 for the same period. Investment income for the financial year as a whole from these sources is expected to outperform the original budget.

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 The Lothbury Property Trust restructure and analysis of their portfolio could result in current investors taking the opportunity to redeem shares in pursuit of shorter term gains. The Trust has exercised the right to delay redemption requests up to 12 months to manage the sale of assets.

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 but not limited to 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.

1.9.2 Treasury Management training was provided for all Members on 19 June 2023 by Link Group.

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 2023.

2) Note the 2022/23 outturn position.

Background papers: contact: Donna Riley

Link interest rate forecast (June 2023)
Link benchmarking data (March 2023)

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