TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

25 September 2023

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 July of the current financial year. A mid-year review of the Treasury Management and Annual Investment Strategy for 2023/24 is also included in this report.

1.1 Introduction

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

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 July of the 2023/24 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2023/24.
- A review of the risk parameters contained in the 2023/24 Treasury Management and Annual Investment Strategy.

1.2 Economic Overview

1.2.1 The Bank of England's Monetary Policy Committee (MPC) is in recess for the month of July but when it meets again in early August, is expected to continue responding to the stickiness of inflation and the continued rise in wages by way of a further increase to the interest rate. The Bank's current forecast reflects:

- CPI inflation has fallen from 7.9% in June to 6.8% in July, marginally above the consensus forecast of 6.7%, but in line with the Bank of England's forecast.
- In July, 0.7% of the decline in CPI inflation was due to the plunge in utility price inflation from 23.3% in June to 4.5% in July. The reduction in the Ofgem utility price cap to £2,075 on 1st July took it below the government's Energy Price Guarantee of £2,500, and meant utility prices fell by 15.1% m/m.
- Core inflation has failed to fall from 6.9% and the rebound in Services inflation from 7.2% to 7.4% reversed out the fall in June, leaving it higher than the Bank of England's forecast of 7.3%.
- A sizeable fall in employment in the three months to June has pushed unemployment up to 4.2% on the q/q basis. Considering single month employment figures, June employment fell by 567,000 which reversed out the big leap of 184,000 employment figure reported for April. This suggests the underlying unemployment rate is nearer to 4.5%.
- There were further falls in the number of job vacancies. The three-month average fell for the 14th consecutive month in July, declining from 1.034m in June to 1.020m. Moreover, the 44,000 rise in the supply of workers in the three months to June helped to alleviate some of the tightness in the labour market. This was also supported by a further 38,000 decline in inactivity as people returned to work from looking after the family and home. Inactivity due to long-term sickness has continued to rise.
- Cooling labour market conditions have not feed through into an easing in wage growth. The monthly rate of earnings growth surged from 0.5% m/m in May to 1.1% m/m in June pushing the headline 3m y/y up from an upwardly-revised 7.2% to 8.2%. The one-off bonus and 5% pay raise for over a million NHS staff was seen as a likely driver of the increase.

1.3 Interest Rate Forecast

1.3.1 Link's forecast used in the 2023/24 Investment Strategy which was approved as part of the budget setting process assumed interest rates would continue to rise in the short term and peak at 4.5% before gradually dropping back over the next three years.

1.3.2 Since the approval of the 2023/24 Investment Strategy CPI inflation has remained stubborn and the MPC has continued to vote in favour of further increased to the Bank Rate to dampen inflation.

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

1.3.3 The latest forecast in Table 1 above sets out the view that both short and long-dated interest rates will remain elevated for some time to come.

1.3.4 Due to the continued volatility in the markets the Link Group reviewed their interest rate projections in July and concluded no further changes to the forecast is needed at this time.

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 2023/24 cash flow surpluses have averaged £25.32m.

1.4.4 The Authority also has £27m 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 investment at the end of July 2023 comprised £5m in property fund investments.

1.4.7 Medium term investments at the end of July 2023 comprised £4.25m in multi asset fund investments.

1.4.8 A full list of investments held on 31 July 2023 is provided at **[Annex 1]** and a copy of our lending list of 31 July 2023 at **[Annex 2]**. The table below provides a summary of funds invested and interest / dividends earned at the end of July.

	Funds invested on 31 July 2023 £m	Average duration to maturity Days	Weighted average rate of return %	SONIA benchmark (average) 1 April to 31 July 2023 %	Interest / dividends earned 1 April to 31 July 2023 £	Gross annualised return %
Cash flow	25.32	8	4.97	5.10	410,020	4.55
Core cash	27.00	154	5.41	5.37	403,480	4.84
Sub-total	**52.32**	83	5.20	5.23	**813,500**	**4.69**
Long term	5.00				45,350	3.63
Medium term	4.25				71,380	5.04
Total	**61.57**				**930,230**	**4.65**

Table 2

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2023.

1.4.9 **Cash flow and Core cash Investments**. Interest earned of £813,500 to the end of July is 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 available to the Council.

1.4.10 Bank offers are expected to continue to rise 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 coming months to refine the projections and the revised level of treasury investment income will be reported to members at a later date.

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 31 June 2023 the Council's return was 4.58% (purple diamond) which is above the local authority benchmarking group average of 4.32%. 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 2023 to 30 June 2023 the £5m investment in property funds generated dividends of £45,350 which represents an annualised return of 3.63% (3.49% in 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 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

1.4.17 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.

1.4.18 Following discussion at the last meeting of the Committee, the Cabinet Member for Finance and Housing and the Chair and Vice Chair of the Audit Committee met with officers to review the position of the Lothbury Property Trust. It was concluded that the new direction of the fund remains intrinsically the same as before but on a reduced scale, and the new strategy will focus on high conviction sectors such as student and commercial accommodation while reducing their position in the office and retail sector. As a result of the useful discussion, I have communicated an expression of interest to Lothbury and will provide a commitment to remain in the fund by mid-September. The final decision to remain needs to be communicated by early October, and at that time I shall produce an officer decision accordingly.

1.4.19 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.

1.4.20 **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 multi-asset (diversified income) funds into the Annual Investment Strategy.

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

1.4.22 In 2021/22 the Council invested a total of £4.25m across Ninety One Diversified Income Fund, Aegon Asset Management Fund and Fidelity Multi Asset Income Fund. 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 31 July 2023 the £4.25m investment in multi asset (diversified income) funds generated income from dividends of £71,380 which represents an annualised return of 5.04%. Income has performed some £20,380 above budget to the end of July.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to July 2023 all of 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 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 July 2023.

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 2023/24 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 a tight labour market and the continued resilience in household spending, the BoE continue to pursue a proactive approach in tackling the stickiness of inflation by continuing to raise Bank Rate which was 5.0% in July.

1.8.2 Link, the independent treasury advisers to the Council, reviewed their June 2023 Bank Rate forecast (Ref: 1.3.1, table 1) and concluded there was no need for a further adjust at this time.

1.8.3 Investment income at the end of July 2023 (month four of the financial year) from cash flow surpluses and core cash investments is a favourable variance of £438,500 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 £20,380 for the same period. Investment income for the financial year as a whole from these sources is expected to outperform the original budget.

1.8.4 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 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.

1.8.8 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.

1.9 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 July 2023.

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

Background papers: contact: Donna Riley

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

Sharon Shelton
Director of Finance and Transformation