TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

26 January 2015

Report of the Director of Finance &Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT UPDATE AND ANNUAL INVESTMENT STRATEGY FOR 2015/16

1.1 The report provides details of investments undertaken and returns achieved in the first nine months of the current financial year and provides an introduction to the Annual Investment Strategy for 2015/16. Members are invited to recommend adoption of the Strategy to Cabinet.

1.2 Introduction

1.2.1 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'.

1.2.2 The Act also requires the Council to set out its Treasury Management Strategy Statement 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.

1.3 Treasury Management Update

1.3.1 In accordance with the CIPFA Treasury Management Code of Practice, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. We continue to find ourselves in a very difficult investment market. Yields are low, in-line with the 0.5% Bank Rate and have been suppressed further by the Bank of England's 'Funding for Lending' scheme. As a consequence, investment returns are expected to remain low relative to pre 2008 financial crisis levels throughout the remainder of this financial year and the next.

1.3.2 Cash flow funds are available on a temporary basis and their amount varies from month to month and during the course of each month dependent on the timing of receipts (collection of business rates, council tax, grants and other sources of income) and payments (to government, precepting authorities, housing benefit recipients, staff and suppliers). The authority holds £13.4m of core cash balances for investment purposes. These funds which comprise our revenue and capital reserves are for the most part available to invest for more than one year.

1.3.3 At the end of December 2014 funds invested and interest earned is set out in the table below:

	Funds invested at 31 Dec 2014 £m	Average duration to maturity Years	Weighted average rate of return %	Interest earned to 31 Dec 2014 £	Gross annualised return %	7 day LIBID benchmark %
In-house cash flow	8.6	0.07	0.69	53,050	0.65	0.35
Externally managed core funds to 31 July	-	0.78 [1]	0.61 [1]	25,500	0.57	0.35
In-house managed core funds from 1 August	13.4	0.25	0.72	40,800	0.72	0.35
Total	22.0	0.18	0.71	119,350	0.65	0.35

[1] Figures shown for comparative purposes represent the values applicable to the externally managed portfolio on 31 July, the day before transfer to In-house management.

1.3.4 Whilst the authority bettered the 7 day LIBID benchmark by 30 basis points, interest earned of £119,350 is £6,150 lower than our 2014/15 original estimate for the same period. This underperformance against budget is attributed to the lower than expected return delivered by our external fund manager in the early part of the financial year and is explored in more detail below.

1.3.5 **Cash flow funds**. Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations. When cash surpluses permit fixed term investments are undertaken to take advantage of the higher yields available.

1.3.6 **Core funds**. Historically these funds have been managed by an external fund manager. They are used to support both revenue and capital expenditure over the next few years of our medium term financial strategy as the Council grapples with savings targets to achieve a balanced budget. The core fund balance of £13.4m is at a level where In-house management is practical without the need for additional staff resources. The 2014/15 Annual Investment Strategy, considered by Audit Committee in January 2014, made provision for these funds to be transferred to In-house management by the end of the financial year and thus contribute to future savings targets through reduced fund management fees. Members are reminded that the transfer to In-house management took place on 1 August 2014.

1.3.7 On 1 August all tradable instruments (gilts, treasury bills and certificates of deposit) which comprised the lion's share (£12.6m) of the core fund were transferred to the Council's custody account with King & Shaxon and the cash balance (£0.8m) transferred to the Council's bank account. With the exception of gilts (£2.2m, 1.25%, July 2018) the fund manager's preference for short duration instruments, typically three months in duration, explains the poor performance referred to at paragraph 1.3.4. However, one benefit from their approach is that all core fund investments have now been replenished by the In-house team. The gilt has also been sold and generated a small capital profit on disposal in October 2014.

1.3.8 Following the transfer, initial core fund maturities were reinvested in nine month term deposits (both fixed and tradable certificates of deposit) to generate yield. Other maturities as they arose were invested in shorter duration instruments (mix of five and six month durations plus cash on deposit) to retain a degree of liquidity. The table at paragraph 1.3.3 demonstrates an improvement in core fund yield such that interest earned is expected to be in-line with budget for the period 1 August to 31 March 2015.

1.3.9 **Current investment position**. A full list of investments held on 2 January 2015 is provided at **[Annex 1]** of this report and a copy of our internal lending list of the same date is provided at **[Annex 2]**.

1.4 Annual Investment Strategy for 2015/16

1.4.1 **Money market funds (MMFs)** form a critical component in our daily cash flow management. They provide the same day access to cash as a traditional bank deposit account; allow surplus cash to be placed in a 'AAA' credit rated product; and ensure our peak monthly cash balances are disbursed across a range of counterparties. The current yield on a typical MMF used by the Council is 0.4% and falls roughly mid-way between the average yield from our bank deposit accounts at 0.6% and that offered by the UK Debt Management Office at 0.25%.

1.4.2 Regulatory changes affecting funds traded in the US have recently been introduced by the Securities and Exchange Commission. Whilst these regulations do not affect funds domiciled in Europe (the ones we use) regulatory reform in Europe is in progress. The exact nature of the reform and when it will be enacted is unclear at the present time and any change will involve a 'bedding-in period' to allow MMFs to adapt to the new requirements. Any impact on our cash management operation for 2015/16 is thought unlikely.

1.4.3 **Stress testing** of UK and EU financial institutions has been in focus during the latter part of 2014. Systematic and regular stress testing has been adopted by both the UK Prudential Regulation Authority (PRA) and the European Banking Authority (EBA) to analyse each banks' resilience to hypothetical adverse macroeconomic scenarios. The tests were initially formulated to highlight any vulnerability present within the tested banks' balance sheets prompting action to improve the banking sector and restore consumer and investor confidence.

1.4.4 The results from the PRA tests were published in December. The tests covered the UK's eight largest banks: Barclays, Co-operative Bank, HSBC, Lloyds Banking Group, Nationwide Building Society, Royal Bank of Scotland Group, Santander UK and Standard Chartered. The PRA tests used tougher benchmarks in comparison to the EBA and placed a strong focus on the housing sector which is consider to be the main risk to domestic financial stability.

1.4.5 With the exception of the Co-operative Bank, the remaining seven UK banks passed the test albeit the part state owned banking groups of the Royal Bank of Scotland and Lloyds fared less well than others. The results of the test didn't alter the credit ratings of the seven banks that passed and the Co-operative Bank has not featured on the Council's lending list for a number of years.

1.4.6 The October report to the Audit Committee included details of a change to **Capita's creditworthiness methodology** which forms part of our assessment of a banks' suitability for inclusion in the Council's lending list. Capita's methodology uses the various components of the rating agency's (Fitch, Moody's and Standard & Poor's) credit rating in a formula to calculate a creditworthiness score for a bank. The lower the score the more creditworthy a bank is deemed to be. The score is also used to determine a maximum duration for fixed term investment.

1.4.7 Throughout the financial crisis the rating agencies have provided some institutions with an uplift to their long and short-term credit ratings to reflect sovereign support. Due to the evolving regulatory regime, these uplifts are going to be removed by the rating agencies. Rather than the bank 'bail-outs' that we have become accustom to (taxpayer investment in RBS and Lloyds) a 'bail-in' by investors will be the norm in the future.

1.4.8 It is important to stress that the change in approach by the rating agencies does not reflect a change in the underlying status of an institution or the credit environment in which they operate, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of Government support will only take place when the regulatory environment has ensured that financial institutions are much stronger and less prone to failure in a crisis should one occur in the future.

1.4.9 All three rating agencies provide a long-term (up to five years) and short-term (up to one year) credit rating. Fitch and Moody's also provide a rating which assesses the ability of a financial institution to meet payment obligations in the absence of any external support (known as the ‘viability’ and ‘financial strength’ ratings). Fitch also provides a separate assessment of the likelihood of and quality of that external support through their ‘support’ rating. In the future these additional rating components will effectively become redundant and as a consequence are now excluded from Capita’s creditworthiness formula. Rating watch and outlook information continues to feature in Capita’s overall assessment as does the market view of risk derived from credit default swap data.

1.4.10 Capita introduced the change in approach in June of this year and at that time it had little impact on their creditworthiness assessments. No banks were removed from the list of suggested counterparties, a few were added and a few had their recommended investment duration increased by one band. However, the long and short-term credit ratings of some banks **may** reduce in the future as the rating agencies remove the uplift derived from sovereign support. No time scale for the change in approach has been given by the rating agencies.

1.4.11 Capita’s amended methodology now implies a minimum long-term credit rating of Fitch ‘A-‘ or equivalent rather than Fitch ‘A’. The minimum short-term credit rating of Fitch ‘F1’ has not altered. Fitch use plus and minus after the letter to denote relative status between financial institutions assigned to the ‘AA’ and ‘A’ rating categories. In the Fitch criteria ‘A’ denotes ‘high credit quality’ and ‘F1’ denotes ‘highest short-term credit quality’.

1.4.12 The Annual Investment Strategy for 2015/16 at **[Appendix 3]** adopts Fitch ’A-‘, ‘F1’ or equivalent as the Council’s minimum credit criteria. The Strategy makes no other changes to the parameters currently in use to limit the Council’s exposure to investment risks.

1.5 Legal Implications

1.5.1 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.

1.5.2 This report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy’s Code of Practice on Treasury Management 2009.

1.6 Financial and Value for Money Considerations

1.6.1 The Bank Rate has remained at a historic low of 0.5% for over 6 years. Capita, our treasury advisors, in common with other market forecasts, anticipate an interest rate rise sometime during the quarter ending December of next financial year.

1.6.2 Investment income is £6,150 below budget at the end of December. The shortfall is attributed to the relatively poor performance achieved by our external fund manager in the early part of the year. Core funds were transferred to In-house management at the beginning of August and investment income for the remainder of the financial year is expected to be in-line with budget.

1.6.3 A small uplift over current returns is anticipated in the budgeted returns for 2015/16 (0.75% cash flow and 1.0% for core funds).

1.6.4 Investment performance is monitored against relevant benchmarks and compared to other local authorities using benchmarking data provided by Capita.

1.7 Risk Assessment

1.7.1 Capita are employed to advise on the content of the Treasury Management Strategy Statement 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.

1.7.2 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 need to be established to ensure an appropriate level of diversification.

1.7.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2015/16 Strategy have been minimised.

1.8 Equality Impact Assessment

1.8.1 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.

1.9 Recommendations

1.9.1 Members are invited to **RECOMMEND** that Cabinet:

1) note the treasury management position as at 31 December 2014;

2) reduce the current minimum long-term credit requirement from Fitch ‘A’ to Fitch ‘A-‘ or equivalent;

3) adopts the Treasury Management Strategy Statement and Annual Investment Strategy for 2015/16 set out at **[Annex 3]**.

Background papers: contact: Mike Withey

Nil

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