TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

23 September 2024

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 2024/25 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 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:

- The Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- The 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 2024/25 financial year including recent benchmarking data.
- Compliance with Treasury and Prudential Limits for 2024/25.
- A review of the risk parameters contained in the 2024/25 Treasury Management and Annual Investment Strategy.

1.2 Economic Overview (as at July 2024)

1.2.1 The Bank of England’s Monetary Policy Committee (MPC) was in recess for the month of July but it was anticipated that by the time it met again in early August, a vote in favour of a reduction by 0.25% to bank rate may be passed. The Bank’s current forecast reflects:

- Monetary policy will need to continue to remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term have dissipated further. The Committee continues to monitor closely the risks of inflation persistence and will decide the appropriate degree of monetary policy restrictiveness at each meeting.
- Twelve-month CPI inflation was at the MPC’s 2% target in both May and June.
- CPI inflation is expected to increase to around 2.75% in the second half of this year, as declines in energy prices last year fall out of the annual comparison, revealing more clearly the prevailing persistence of domestic inflationary pressures.
- In the MPC’s modal projection conditioned on the market-implied path of interest rates, CPI inflation falls back to 1.7% in two years’ time and to 1.5% in three years, reflecting the continued restrictive stance of monetary policy and the emergence of a margin of slack in the economy. CPI inflation is 2.0% and 1.8% at the two and three-year horizons respectively. The risks around the modal CPI projection are skewed somewhat to the upside throughout the forecast period, reflecting more persistence in domestic wage and price-setting.
- GDP expanded 0.7% y/y in June 2024 half the 1.4% growth seen in May and slightly below forecasts of 0.8%. The economy stalled in June from May 2024, following a 0.4% growth in the previous period, and matching market forecasts.
- The economy expanded 0.9% y/y in Q2 2024, the biggest annual growth rate since Q3 2022, compared to 0.3% in Q1, and q/q by 0.6% in Q2 2024, following a 0.7% rise in Q1 and in line with forecasts.
- The annual inflation rate in the UK edged up to 2.2% in July 2024 from 2% in June, but below forecasts of 2.3%.
- The number of people employed in the UK increased by 97k in the three months to June 2024, growing for the second consecutive period after a 19k rise in the previous three months.

- The UK's unemployment rate fell to 4.2% from April to June 2024, down from a two-and-a-half-year high of 4.4% in the previous period and below market forecasts of 4.5%. The number of unemployed individuals decreased by 51k to a total of 1.44m, driven by declines in those unemployed for up to 6 months, bringing the figure below last year's levels.

1.3 Interest Rate Forecast

1.3.1 Link's forecast used in the 2024/25 Investment Strategy which was approved as part of the budget setting process assumed interest rates would peak at 5.25% before gradually dropping back to 3% over the next three years. There has been a minor adjustment to the reprofiling toward the end of the three year period.

1.3.2 Since the approval of the 2024/25 Investment Strategy CPI inflation has continued to fall back. After seven consecutive meetings where the MPC voted to hold Bank Rate at 5.25%, July's meeting saw the Committee vote in favour of a reduction bringing the Bank Rate to 5.0%.

Link - July 2024	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
	%	%	%	%	%	%	%	%	%	%	%
Bank Rate	5.25	5.00	4.50	4.00	3.50	3.25	3.25	3.25	3.25	3.00	3.00
3 mth ave earnings	5.30	5.00	4.50	4.00	3.50	3.30	3.30	3.30	3.30	3.00	3.00
6 mth ave earnings	5.30	4.90	4.40	3.90	3.50	3.30	3.30	3.30	3.30	3.10	3.10
12 mth ave earnings	5.10	4.80	4.30	3.80	3.50	3.40	3.40	3.40	3.40	3.20	3.30
25yr PWLB	5.30	5.20	5.00	4.80	4.70	4.50	4.50	4.40	4.40	4.40	4.30

Table 1

1.3.3 The latest forecast in Table 1 above sets out the view that both short and long-dated interest rates are expected to decrease gradually over the next two years, settling at 3%.

1.3.4 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 2024/25 cash flow surpluses have averaged £20.92m.

1.4.4 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.

1.4.5 Cash flow and core cash balances also include sums to meet business rate appeals which are expected to be resolved in 20234/25 and future years.

1.4.6 Long term investment at the end of July 2024 comprised £4.22m in property fund investments.

1.4.7 Medium term investments at the end of July 2024 comprised £4.25m in multi asset fund investments.

1.4.8 The full list of investments held on 31 July 2024 is provided at **[Annex 1]** and a copy of our lending list of 31 July 2024 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 2024 £m	Average duration to maturity Days	Weighted average rate of return 1 April to 31 July 2024 %	SONIA benchmark July 2024 %	Interest / dividends earned 1 April to 31 July 2024 £	Gross annualised return %
Cash flow	20.92	5	5.23	5.15	439,420	5.41
Core cash	30.00	148	5.34	5.09	552,220	5.53
Long term	4.22				40,320	3.21
Medium term	4.25				58,980	4.16
Total	**59.39**				**1,090,940**	**--**

Table 2

Property funds pay dividends quarterly. The return quoted above is based on dividends received for the quarter April to June 2024.

1.4.9 **Cash flow and Core cash Investments**. Interest earned of £991,640 to the end of July is higher than the original estimate for the same period. The increase in income reflects the interest rate maintained at 5.25% for longer than anticipated, providing the Council with favourable investment opportunities.

1.4.10 Future investments are expected to yield lower investment income now that markets are factoring in future cuts to the bank rate in 2024/25 and 2025/26, with the rates expected to settle around the 3% marker. Investment income for 2024/25 is expected to have a positive variance against the original budget and further analysis will take place 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 2024, the Council's return was 5.39% (purple diamond) which is above the local authority benchmarking group average of 5.22%. 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 2024 to 30 June 2024 the £4.22m investment in property funds generated dividends of £40,320 which represents an annualised return of 3.21% (3.63% in 2023/24). The long term investment figure set out in Table 2 has been reduced to take into account the repayment of capital investment from the sale of assets by Lothbury Property Trust, which terminated on 30 May 2024.

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 31 July 2024 c £	31 July sale value above (below) purchase price (c-a) £
LAPF (Primary, July 2017)	1,000,000	922,200	875,670	(124,330)
Hermes (Secondary, Oct 2017)	1,000,000	939,000	874,600	(125,400)
LAPF (Primary, June 2018)	1,000,000	922,200	839,600	(160,400)
Total change in principal	**3,000,000**	**2,783,400**	**2,589,870**	**(410,130)**
			Total dividends received to June 2024	**768,040**
Table 3			**Net benefit since inception**	**357,910**

1.4.17 Since inception, the Council has received dividends from its property fund investments (excluding Lothbury Property Trust) of £768,040, providing a net benefit of £357,910 (Table 3). All property fund investments recorded capital depreciation in the period April 2024 to June 2024.

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 £	Principal Investment Received c £	Principal Investment Balance Outstanding £
Lothbury Property Trust	2,000,000	1,900,700	853,850	(1,146,150)
			Total dividends received to June 2024	**360,220**
Table 4			**Net balance to breakeven point**	**(785,930)**

1.4.18 Lothbury Property Trust terminated on 30 May 2024 after negotiations to merge the fund were unsuccessful. As per Table 4 above, we have, to date, received three payments totalling £853,850 of our initial investment. The remaining assets are expected to be sold by December 2024, distributions will be made as and when asset sales have concluded, and dividends paid from income generating assets. Taking into account the dividends received from the inception of the fund, the breakeven point would be the recovery of £785,930 against the outstanding assets for sale.

1.4.19 At the end of June 2024 Hermes Property Trust, having received a redemption request for approximately 22% of the fund, announced they would be seeking investor approval on a proposal to gate the fund. The EGM vote was 71.3% in favour of the resolution which was short of the 75% needed to pass. The Fund has appointed CBRE Capital Advisors to provide an independent report on options available which should be distributed by the end of September 2024. Further updates will be shared with Members in due course.

1.4.20 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.

1.4.21 **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 was reaffirmed in the January 2021 Audit Committee report which introduced multi-asset (diversified income) funds into the Annual Investment Strategy.

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

1.4.23 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 when resources become available from asset disposals and other windfalls.

1.4.24 During the period 1 April 2024 to 31 July 2024 the £4.25m investment in multi asset (diversified income) funds generated income from dividends of £58,980 which represents an annualised return of 4.16%. The performance of the cumulative funds fall slightly short of the budget to the end of July by £2,180.

1.5 Compliance with the Treasury Management and Annual Investment Strategy

1.5.1 Throughout the period April to July 2024 all of the requirements contained in the 2024/25 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 2024.

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 2024/25 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**. **However, future consideration will be given to the inclusion of borrowing and debt rescheduling in anticipation of the future needs of the Council.** 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 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 CPI inflation in both May and June was at the MPC's 2% target. However, it is expected to increase to around 2.75% in the second half of the year which will reveal more clearly the persistence of domestic inflationary pressures. This is turn could influence the rate at which the MPC reduces bank rate further.

1.8.2 Link, the independent treasury advisers to the Council, reviewed their July 2024 Bank Rate forecast (Ref: 1.3.2, Table 1) and concluded there was no need for a further adjustment at this time.

1.8.3 Investment income at the end of July 2024 from cash flow surpluses and core cash investments is a favourable variance of £288,640 to the budget for the same period. Income from property funds at the end of June falls short of the budget by £21,350 mainly attributable to reduced dividends received from Lothbury as their asset base reduces. Diversified income funds are marginally lower than the budget by some £2,180 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 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 over time 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 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 2024.

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

Background papers: contact: Donna Riley

Link benchmarking data (June 2024)
Link interest rate forecast (July 2024)

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