Meeting: Council  Date: 22 October 2015

**Wards Affected:** All Wards in Torbay

**Report Title:** Treasury Management Mid-Year Review 2015/16

**Is the decision a key decision?** No

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## 1. Proposal and Introduction

1.1 This report provides a mid-year review of Treasury Management activities during the first part of 2015/16. The Treasury function aims to support the provision of all Council services through management of the Council's cash flow and debt & investment operations.

1.2 The key points in the Treasury Management review are as follows:

- Bank Rate not forecast to rise until 2016
- Investment portfolio remains exposed to limited opportunities in terms of rates and suitable counterparties
- The Council's return on investments out-performs the market and Local Authority benchmarks
- No economic opportunities to reduce levels of borrowing
- Treasury Management activities are expected to generate a net Revenue Budget saving of £200k in 2015/16.
- An evaluation of alternative investments has resulted in limited opportunity and Member appetite to diversify into higher risk instruments.

## 2. Reason for Proposal

2.1 The preparation of a mid year review on the performance of the treasury management function forms part of the minimum formal reporting arrangements required by the CIPFA Code of Practice for Treasury Management.

2.2 Audit Committee, at its meeting in January 2015, instructed officers to evaluate opportunities to diversify the investment portfolio into higher risk/higher yield instruments. The analysis at Appendix 3 was presented to the Committee on 23 September and their view is incorporated into the recommendations.

## 3. Recommendations of the Audit Committee

3.1 that the Treasury Management decisions made during 2015/16 the first part of 2015/16 as detailed in the submitted report be noted;

3.2 that the Prudential and Treasury Indicators as set out in Appendix 2 of the submitted report be noted; and

3.3 that the Council be recommended to vary the Annual Investment Strategy to allow diversification of the investment portfolio into higher risk investments, initially on an experimental basis, and approve investment in a combination of two or three of the following instruments;

- peer to peer lending – with overall investment of £100,000; maximum individual loan amount of £1,000; maximum loan term of three years; and a maximum credit rating "B";
- The Local Authorities Property Fund.

## 4. Background Information

4.1 The Treasury Management Strategy for 2015/16 was approved by Council on 5th February 2015.

4.2 The Council defines its treasury management activities as:

***"The management of the authority's investments and cash flows, it's banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".***

4.3 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by the Council on 25th March 2010.

4.4 This mid year review has been prepared in compliance with the CIPFA Code of Practice and covers the following in Appendix 1 to this report:

- Interest Rate update;
- Review of the Council's Borrowing strategy;
- Review of the Council Investments 2015/16;
- Revenue Budget Performance
- Compliance with Prudential Limits for 2015/16.
- Alternative Investments

## 5. Interest Rate Update

5.1 As forecast, interest rates have remained at historically low levels.

5.2 Despite concerns of rising earnings the Monetary Policy Committee have recently voted to maintain the Bank rate at 0.5% by eight votes to one. Any rise in Bank Rate is not expected until 2016.

5.3 The current view on interest rates (as at August 2015) of the Council's advisors, Capita Asset Services, is shown below:

| | Now | Sep-15 | Dec-15 | Mar-16 | June-16 | Sep-16 | Dec-16 |
|---|---|---|---|---|---|---|---|
| BANK RATE | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 |
| | | | | | | | |
| 5yr PWLB | 2.19 | 2.30 | 2.40 | 2.50 | 2.60 | 2.80 | 2.90 |
| 10yr PWLB | 2.77 | 2.90 | 3.00 | 3.20 | 3.30 | 3.40 | 3.50 |
| 25yr PWLB | 3.31 | 3.40 | 3.60 | 3.80 | 3.90 | 4.00 | 4.10 |
| 50yr PWLB | 3.17 | 3.40 | 3.60 | 3.80 | 3.90 | 4.00 | 4.10 |

## 6. Borrowing Portfolio 2015/16

6.1 The current and expected levels of borrowing rates provide no economic opportunity to make any early repayment of borrowing in line with the preferred strategy

6.2 No new borrowing is anticipated in 2015/16.

## 7. Investments Portfolio 2015/16

7.1 The portfolio includes a number of one to two year duration deposits with the part-nationalised banks.

7.2 Going forward, officers are conscious that the new government is likely to step up the divestment of Lloyds Bank and accordingly have recently re-classified the Bank to a higher risk level within the counterparty policy. Existing exposure in the Bank will be unwound naturally as deposits mature to comply with the associated lower investment limits.

7.3 This re-classification will add significant additional pressure on the investment portfolio both in terms of available counterparties and the lower level of returns available.

7.4 Greater use has been made of AAA rated Money Market Funds to gain a slight improvement on return of liquidity monies.

7.5 In considering the Treasury Management Strategy for 2015/16 the Audit Committee requested Officers to evaluate and report on the impact of diversifying into new higher risk investment instruments. A number of options were presented at a Members event on 7th September 2015. A discussion paper is provided at Appendix 3 to this report.

7.5.1 Subsequent to the Audit Committee meeting of 23rd September 2015, Capita Asset Services has expressed some concerns in regard to a Multi Asset Fund meeting the Council's investment criteria and consequently officers have withdrawn this investment option for the time being.

7.5.2 The s151 Officer has existing authority to invest in the Local Authorities' Property Fund through the Annual Investment Strategy but, in light of initial feedback from Members, will not undertake this option unless given full backing by Council.

7.5.3 Audit Committee was supportive of investment in peer to peer lending and the proposal is included within the recommendations of this report.

7.5.4 The original recommendation proposed and confirmed by Audit Committee for the higher risk investments was:

"that the Council be recommended to vary the Annual Investment Strategy to allow diversification of the investment portfolio into higher risk investments, initially on an experimental basis, and approve investment in a combination of two or three of the following instruments;

- peer to peer lending – with overall investment of £100,000; maximum individual loan amount of £1,000; maximum loan term of three years; and a maximum credit rating "B";
- Multi Asset Fund pending Capita advice; and
- The Local Authorities Property Fund."

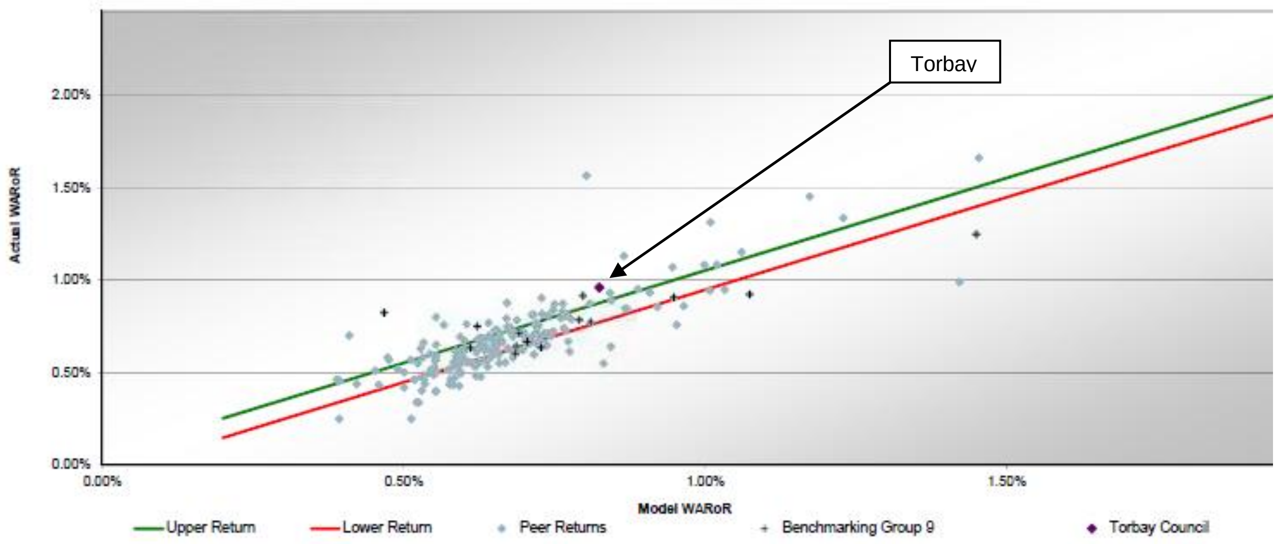
7.5.5 Following the discussions with Capita Asset Services outlined in 7.5.1 the Multi Asset Fund was withdrawn from the final recommendation presented at para 3.3 of this report.

7.6 The external Fund Manager, Aberdeen Asset Management, held £30M of Council funds at the end of July 2015. The Fund has continued to add value to the Council's overall return and counterparty/instrument diversity although returns have been hit by market conditions over the past couple of months.

7.7 A comparison of the Council's investment performance to date against peer Local Authorities is given below and illustrated in the following graph:

| | **Torbay Performance Rate** | **Market Benchmark (7-day LIBID)** | **Capita Benchmarking** | |
|---|---|---|---|---|
| | | | Local Group | English Unitaries |
| Weighted Average Rate of Return **at 31/07/15**<br>- In House | 0.96% | 0.35% | 0.80% | 0.77% |
| -External Fund Manager (net of fees)* | 0.70% | 0.35% | N/A | N/A |
| -Combined | 0.86% | 0.35% | | |

Population Returns against Model Returns




| | Actual WARoR | Model WARoR | Difference | Lower Bound | Upper Bound | Performance |
|---|---|---|---|---|---|---|
| Torbay Council | 0.96% | 0.82% | 0.14% | 0.77% | 0.88% | Above |

Source: Capita Asset Services

8. **Revenue Budget Performance**

8.1 Treasury Management activities are currently forecast to underspend the approved net budget target for 2015/16 by £200k.

| | **Original Budget 2015/16** | **Projected Outturn 2015/16** | **Variation** |
|---|---|---|---|
| | **£M** | **£M** | **£M** |
| Investment Income | (0.6) | (0.7) | (0.1) |
| Interest Paid on Borrowing | 6.1 | 6.1 | 0.0 |
| **Net Position (Interest)** | **5.5** | **5.4** | **(0.1)** |
| | | | |
| Minimum Revenue Provision | 4.7 | 4.7 | 0.0 |
| PFI Grant re: MRP | (0.5) | (0.5) | 0.0 |
| Unsupported Borrowing Recharges | (2.0) | (1.9) | 0.1 |
| Premiums on Borrowing Repayment | 0.2 | 0 | (0.2) |
| **Net Position (Other)** | **2.4** | **2.3** | **(0.1)** |
| | | | |
| **Net Position Overall** | **7.9** | **7.7** | **(0.2)** |

**Appendices**

Appendix 1: Counterparties where funds were deposited (April 2015 – July 2015)

Appendix 2: Prudential Indicators 2015/16

Appendix 3: Alternative Investments

**Background Documents**

Treasury Management Strategy 2015/16

Aberdeen Asset Management – Global Multi Asset Income Fund presentation

Local Authorities' Property Fund Factsheet

**Appendix 1**

## Counterparties with which funds were deposited (April 2015 – July 2015)

### Banks and Building Societies

| | |
|---|---|
| Barclays Bank | (UK) |
| Lloyds Bank | (UK) |
| Royal Bank of Scotland/National Westminster | (UK – part nationalised) |
| Svenska Handelsbanken | (Sweden) |
| Goldman Sachs International Bank | (UK) |

### Local Authorities

Greater London Authority

### Other Approved Institutions

Goldman Sachs Sterling Liquid Reserves Fund
Public Sector Deposit Fund
Aberdeen Asset Management

**Appendix 2**

## ANALYSIS OF TREASURY MANAGEMENT PRUDENTIAL INDICATORS AGAINST APPROVED 2015/16 TARGETS AT END JULY 2015

| TREASURY MANAGEMENT PRUDENTIAL INDICATORS | 2015/16 LIMIT | As at 31/07/15 |
|---|---|---|
| | **£M** | **£M** |
| **Authorised limit for external debt** - | | |
| borrowing | 167 | 138 |
| other long term liabilities | 40 | 8 |
| TOTAL | 207 | 146 |
| This is the Statutory "affordable borrowing limit" required under section 3(1) of the Local Government Act 2003. Impending breach would require the Council to take avoiding action.<br>**Borrowing Levels are within the Authorised Limit – no action required** | | |
| **Operational boundary for external debt -** | | |
| borrowing | 148 | 138 |
| other long term liabilities | 40 | 8 |
| TOTAL | 188 | 146 |
| This is the most likely, but not worst case scenario for day-to-day cash management purposes. This indicator provides an early warning for a potential breach in the Authorised Limit. Occasional breach of this limit is not serious but sustained breach would indicate that prudential boundaries the Council has set may be exceeded, requiring immediate Council action.<br>**Borrowing Levels are within the Operational Boundary – no action required** | | |

| TREASURY MANAGEMENT PRUDENTIAL INDICATORS | 2015/16 LIMIT | As at 31/07/15 |
|---|---|---|
| **Limit for fixed interest rate exposure** | **%** | **%** |
| Debt | 100 | 100 |
| Investments | 80 | 52 |
| **Limit for variable rate exposure** | | |
| Debt | 30 | 0 |
| Investments | 75 | 47 |

The Code requires the Council to set ranges on its exposure to the effects of changes on interest rates. Fixed rate borrowing and investments can contribute to reducing the uncertainty surrounding future interest rates. However, a degree of use of variable interest rates on part of the treasury management portfolio may benefit performance.
The limit for fixed rate exposure has been set to allow for the Council's entire debt to be locked in at low fixed rates.
The limit for variable rate exposure reflects the Council's use of notice accounts for liquidity of the investment portfolio and the external Fund manager holding
**Rate exposures are within the approved limits – no action required.**

| | 2015/16 LIMIT £M | As at 31/07/15 £M |
|---|---|---|
| **Upper limit for total principal sums invested for over 364 days** (per maturity date) | 51 | 21 |

The purpose of this indicator is to contain the Council's exposure to the possibility of losses that might arise as a result of it having to seek early repayment or redemption of principal sums invested. The 2015/16 limit applies to funds administered by the external fund manager and also allows for in-house core cash balances to be placed out longer term to gain enhanced returns while maintaining sufficient liquidity.
**The position above represents round 26% of the total portfolio held in longer term investments.**

| Maturity structure of fixed rate borrowing during 2015/16 | Upper limit | lower limit | As at 31/07/15 |
|---|---|---|---|
| Up to 10 years | 50% | 5% | 14% |
| 10 to 20 years | 50% | 5% | 19% |
| 20 to 30 years | 60% | 10% | 25% |
| 30 to 40 years | 50% | 10% | 25% |
| Over 40 years | 50% | 0% | 17% |

The Prudential Code is designed to assist authorities avoid large concentrations of fixed rate debt that has the same maturity structure and would therefore need to be replaced at the same time.

Appendix 3

**Alternative Investments**

## 1 Context and Background

Extract from CLG Investments Guidance
"*The guidance defines a prudent investment policy as having two objectives: achieving first of all* ***security*** *(protecting the capital sum from loss) and then* ***liquidity*** *(keeping the money readily available for expenditure when needed) ...... Once proper levels of security and liquidity are determined, it will then be reasonable to consider what* ***yield*** *can be obtained consistent with those priorities. This widely-recognised investment policy is sometimes more informally and memorably expressed as follows:*

*__S__ecurity - __L__iquidity -__Y__ield …in that order!"*

Extract from CIPFA Code of Practice for Treasury Management
*"[The Organisation's] policies and practices should make clear that the effective management and control of risk are prime objectives of their treasury management activities and that responsibility for these lies clearly within their organisations. Their appetite for risk should form part of their annual strategy and should ensure that* ***priority is given to security and liquidity when investing funds****."*

1.1 The Council's risk appetite on investments has closely aligned to the letter of the Regulating guidance with the in-house team generally investing in simple instruments with only a remote risk of capital loss.

1.2 In previous years there were enhanced rates available to Local Authorities which made consideration of increasing risk fairly redundant. These enhanced rates have now been withdrawn by Banks and the Council's investment portfolio is now experiencing the dual pressures of low returns and limited counterparty availability.

1.3 The current budgeted target for investment income is £600k with current investment performance around 0.80%. An additional 1% over the current rate would increase income by £10,000 for every £1million invested.

1.4 In response to a request by Audit Committee at its meeting in January 2015, this discussion paper has been prepared for the Committee to assess the impact and appropriateness of diversifying the Council's investments into higher risk/higher yielding instruments.

1.5 Officers have looked at various markets and a briefing was held for Members on 7$^{th}$ September with presentations on three particular instruments

## 2 Aberdeen Asset Management –Multi Asset Fund

2.1 The Council's external fund manager has offered up a multi-asset fund solution which they believe will add value while controlling overall risk.

2.2 Aberdeen already uses a diverse range of instrument within the Council's specified risk criteria. This new management option would blend the existing holdings with controlled exposure to other, more volatile funds e.g.: property, equities, sovereign debt and frontier debt.

2.3 It is envisaged that only small proportions of the Fund would be exposed to the new assets and liquidity would be maintained with repayments settlements at T+4 days.

2.4 The Council will be able to set a target rate and reject the use of any asset class it feels is outside it's legal powers (although this may impact on the achievable return)

2.5 This is a new fund and as yet no performance data is available although figures are anticipated during October. Aberdeen are also meeting with the Council's advisors, Capita Asset Services in early October and officers suggest that any transfer to the new fund is held pending an evaluation from Capita.

2.6 A Council decision is required to add the multi-asset fund to the approved investments within the Annual Investment Strategy including operational limits.

2.7 <u>Risks</u>

| Positive | Negative |
|---|---|
| • Target rate of 4.50% (gross)<br>• Proven track record with Council funds<br>• Opportunities for diversity into greater range of uncorrelated instruments thereby controlling risk<br>• Simple to manage alongside existing fund arrangements<br>• Liquidity – settlement T+4 days<br>• Flexibility to set target rate and exclude particular assets<br>• Consistent level of annual return | • New fund - Performance data not yet available.<br>• Restriction of asset classes by Council could restrict yields<br>• Annual Fee of 0.25% of fund balance (0.15% on current fund)<br>• Requires a 3 year investment horizon |

<u>Audit Committee</u>

2.8 Audit Committee was generally supportive of diversifying into the Fund subject to the evaluation by Capita Asset Services

2.9 Capita presented their findings following the Audit Committee meeting and highlighted concerns in terms of a Multi Asset Fund meeting the Council's investment criteria.

2.10 Consequently, officers have withdrawn the Multi-Asset Fund investment option at this time.

## 3 CCLA Ltd – Local Authorities’ Property Fund (LAPF)

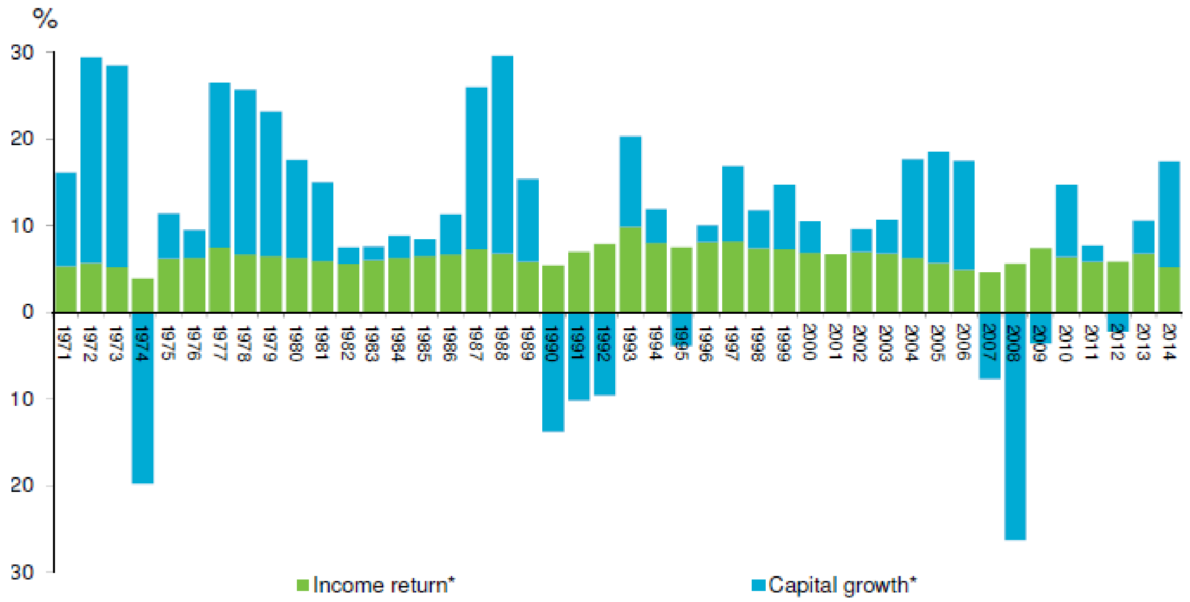
3.1 Property funds invest in commercial properties and provide returns from income, through rental streams, and from capital growth. The LAPF is a particular fund operated solely for Local Authority membership which stands at 123 (including parishes and a total fund size of £380million.

3.2 Capita has supplied a summary analysis of returns achieved by property funds overall shown below alongside the LAPF’s published returns for comparison.

| Fund Performance (net) 31/03/2015 | Best Performing Fund | Worst Performing Fund | The Local Authorities’ Property Fund |
|---|---|---|---|
| 3 Months | 4.3% | 0.8% | na |
| 1 Year | 24.4% | 10.1% | 17.8% |
| 3 Years Annualised | 16.8% | 8.4% | 11.8% |
| 5 Years Annualised | 10.8% | 7.9% | 10.6% |

3.3 The table in 3.1 illustrates the potential for returns far in excess of the Council’s current performance. However, the volatility of property values can lead to annual losses which is illustrated the long term history below.

**Property investment returns since 1970**




Source: CCLA and IPD

3.4 Capital growth is generally high yielding but is volatile. Income yields are consistent (generally between 5% and 10%) year on year due to the quality of contracted lease tenants.

3.5 The acquisition of shares in a property fund usually constitutes capital expenditure with the requirement for Local Authorities to provide a revenue provision for repayment (MRP).
However, the CCLA Property Fund is approved by HM Treasury under section 11(1) of the Trustee Investment Act 1961 and in accordance with section 25(3) (d) of the regulations it is exempt from classification as capital expenditure.

3.6 Fees applicable to property funds are generally high with an annual management fee and exit and entry & exit charges at indicative levels of 7% and 1.5%.
CCLA charge an annual management fee of 0.65% and further charges to cover costs (ie stamp duty and agents fees) equate to 7.3%.

3.7 Investment in a property fund should be treated as a long term investment to ensure total returns cover fees and any capital loss within the investment period. It is therefore only appropriate for core cash. Property is an illiquid asset class and it is not always possible to sell units quickly. As such an investment horizon for these funds should be a minimum of 5 years.

3.8 <u>Risks</u>

| Positive | Negative |
|---|---|
| • Potential for yields significantly above the Council's current investment return.<br><br>• LAPF management ethos based on bespoke Local Authority requirements.<br><br>• Exemption from classification as capital expenditure (LAPF only) | • Possible annual capital losses due to volatility of property values<br><br>• High fee level<br><br>• Long term investment horizon<br><br>• Illiquid |

<u>Audit Committee</u>

3.9 While recognising the potential returns of the Fund and its management ethos, Audit Committee was mindful of feedback from Members attending the presentation. Concerns centred on the high entry fee and confidence in the Council's available cash levels over a five year term.

3.10 As such the Committee was unable to propose the LAPF option to Council.

3.11 While the s151 officer has authority to use the Fund under the current Annual Investment Strategy, in light of the initial feedback from Members, this option will not be exercised unless given full backing by Council.

## 4 Peer to Peer Lending

4.1 Peer-to-peer lending websites work by enabling savers/investors to lend directly to borrowers. Banks are cut out and without their margins participants can get slightly better rate deals than through traditional loan methods.

4.2 As part of the Business Finance Partnership scheme the government has committed £60million of funding to British businesses through the Funding Circle website. Over a dozen Local Authorities are lending through Funding Circle, predominantly to local businesses.

4.3 The Funding Circle has facilitated over £796million of loans and there are over 42,000 live lenders.

4.4 Borrowers are checked and assessed by the website and categorised as to risk (A+ to E). Lenders set their own risk and rate appetite and can select appropriate loans themselves (bespoke lending) or delegate the task to an automated process. This process spreads an investment over a number of loans, the lender taking a share (loan "part") in the overall loan total.

4.5 It is recommended that an investment is diversified over at least 100 different loan parts to spread the risk of any capital loss through bad loans. It may take some time to lend out a full investment amount and any unlent cash will not attract interest.

4.6 Repayments are usually in monthly instalments and collected by the website.

4.7 The table below provides the estimated level of bad debt applicable to each risk category. Any participation in peer to peer lending must assume an element of capital loss but evidence strongly suggests that this is more than offset by the gross interest return.

| A+ | A | B | C | D | E | Total |
|---|---|---|---|---|---|---|
| 0.6% | 1.5% | 2.3% | 3.3% | 5.0% | 8.0% | 1.9% |

Source: Funding Circle

4.8 The Funding Circle levies a servicing fee of 1% of outstanding principal deducted from loan repayments.

4.9 The advertised net return after fees and bad debt is 7.2% assuming an investment is spread over a range of risk categories and durations. This indicative level has been corroborated by personal experiences within the Council arena.

4.10 While loans through peer to peer are generally fixed term, investors can realise their cash early by selling the loan parts they hold in a secondary market. This would be dependent on available buyers and selling price which could lead to a loss (or profit) on the investment return.

4.11 Use of peer to peer lending will require a Council decision to incorporate into the Annual Investment Strategy together with operational limits.
To qualify as a Treasury Management instrument loans would have to be available to all UK businesses within a specified risk framework. However, the policy could also include an aspiration to lend to local businesses on a loan by loan basis if opportunities arise.

4.12 Risks

| Positive | Negative |
| --- | --- |
| • High net returns available significantly above Council's current performance<br>• Diversification over a wide range of loan parts<br>• Council can set its risk parameters<br>• Liquidity through selling of loan parts | • Tangible risk of capital losses<br>• May take some time to lend the full investment allocation<br>• No interest payable on unlent cash<br>• Fee of 1% of outstanding principal<br>• Medium to long term investment horizons |

Audit Committee

4.13 Following testimonies of positive experiences within the Council arena Audit Committee was supportive of investing in peer to peer lending, initially on an experimental basis to allow officers to assess the resource implications and viability of the lending process.

4.14 It was suggested that exposure be limited initially to a maximum investment of £100,000 with lending to anyone business limited to a maximum of £1,000.

4.15 It was further suggested that limits be placed on loan duration (3 years maximum) and credit quality (minimum 'B' based on Funding Circle rating criteria).

4.16 The motion and suggested limits have been included within the report recommendations.