City of Westminster

Audit & Performance Committee

Date:	2 May 2019
Classification:	General Release
Title:	**Integrated Investment Framework 2018/19 Outturn**
Wards Affected:	All
Policy Context:	To manage the Council's finances prudently and efficiently.
Cabinet Member	Cabinet Member for Finance, Property and Corporate Services
Financial Summary:	This report forms part of the monitoring process (outturn position) of the Integrated Investment Framework.
Report of:	Gerald Almeroth Executive Director for Finance and Resources

1. EXECUTIVE SUMMARY

1.1. The purpose of this report is to present the Outturn Report for 2018/19 for the Council's Investment Framework.

2. RECOMMENDATION

2.1. Cabinet is asked to note the Investment Framework outturn 2018/19.

3. BACKGROUND

3.1. On 7 March 2018, Full Council gave approval to implement a comprehensive strategic integrated investment framework for bringing together and managing all its investments within the approval of an Integrated Investment Framework.

3.2. The Council holds £729.0m of short term cash based investments (as at 31 March 2019), managed under the Treasury Management Strategy Statement (TMSS), which passes through Scrutiny, Cabinet and Full Council on an annual basis.

3.3. The Council also owns a significant number of Investment Properties, revalued as at 31 March 2019 at £472.7m, which are considered as part of the Capital Programme.

3.4. The Council holds a number of long term loans and equity shareholdings.

3.5. In addition, the Council is responsible for managing the Westminster Pension Fund which has net assets of £1.403bn (valued at 31 March 2019), and operates under the Investment Strategy Statement (ISS) set by the Pension Fund Committee. Investments held as part of the Council's Pension Fund are managed under a separate regulatory framework and are outside the scope of this report from the point of view of investment management.

4. RISK LEVELS

4.1. The Investment Framework has focused on:

- investments with a reasonable return based on reasonable risk;
- other Treasury opportunities not covered in the TMSS; and
- property investment opportunities.

4.2. The Council has sought to obtain the maximum amount of income consistent with an optimum level of risk, and is willing to accept a lower level of income in exchange for a lower risk product which does not expose the capital value of the investment to potential loss. Security of capital and liquidity requirements are higher priorities than investment yield.

4.3. Westminster City Council's capital programme has a forecast net funding requirement of £1.765bn over the next 15 years including 2018/19. Of this funding requirement, between £0.9bn and £1bn will need to be resourced using borrowing from external providers in this period. Thus, with regard to the Treasury portfolio, the need to take liquidity into account is extremely important.

5. EXPECTED TREASURY BALANCES AND BUDGETED INCOME/EXPENDITURE

5.1. The budgeted average Treasury balance for 2018/19 was £1.2 billion. The actual average investment balance for the year was £1.172 billion. The Treasury balance peaked in June 2018 at £1.294 billion and then fell to £729.0 million at 31 March 2019.

5.2. The table below shows the actual investment income and expenditure achieved in the year, the budget and the variance.

	Budget £000	Actual £000	Variance £000
Investment Income	5,575	11,148	5,573
Interest Payable	12,293	10,626	-1,667

6. CURRENT INVESTMENT ACTIVITY

6.1. The Council is responsible for managing three investment portfolios:

- the Council treasury investment portfolio of £729.0m comprising of short/medium term cash-based investments generating a current return of 1.01%;
- the investment property portfolio of £472.7m, generating 3.1% net of direct costs; and
- the City of Westminster Pension Fund of £1.403bn with an assumed long-term investment return of 5.1%.

6.2. The Council investment portfolio is set out below.

Type of Investment	Expected rate of return	Value at 31 March 2019 £m	Value at 31 March 2018 £m
Short term investments (mostly overnight cash deposits, money market etc.)	1.01	729.0	992.2
Long term investments in shareholdings in controlled companies such as CityWest Homes, Westminster Community Homes, WestCo trading etc.	5% average	27.5	27.5
Property Fund Partnership (Lettings Fund)	3.2%	26.0	15.0
Investment properties	3.1%	472.7	385.0
Total		**1,255.2**	**1,419.7**

6.3. The Pension Fund is a separate legal entity and, therefore, its assets cannot fit within the wider investment framework of the Council. However, despite this ring-fencing, the pension fund has a significant impact on the Council's financial position and funding needs, because of the existing deficit in the scheme, and the contribution plan in place to close this over a 15-year horizon (from 1 April 2019).

6.4. The funding position of the Pension Fund has improved from 74% at 31 March 2013 to 94.5% at 31 December 2018. City of Westminster (as an employer within the Pension Fund) has an outstanding deficit of £157.5m at 31 December 2018.

6.5. The funding of the Pension Fund assumes an annualised rate of return of 5.1% over the 15-year recovery period as represented in the discount rate used to value the pension fund liabilities. From the Council perspective, as an employer paying into the Pension Fund, any deficit represents a form of borrowing with an interest rate set at the discount rate of 5.1%.

7. SHORT-TERM INVESTMENTS

7.1. In line with the current investment strategy, the treasury portfolio of short term cash-based investments with 48% bank based deposits, 36% in local authorities, 8% in money market funds, 8% in government bonds.

7.2. Investment in bank based deposits are made according to minimum required ratings (provided by Moody's, Standard and Poor and Fitch) as stipulated in the TMSS. Local authority investment decisions are transacted based on due diligence sourced by officers from the latest published financial statements, external audit reports, current expenditure outturn/forecasts and current/anticipated positions with regard to the expected use of useable reserves to fund current and future budget deficits.

7.3. This approach provides flexibility for the Council at very low levels of risk, but tends to result in fairly low returns, currently at 1.01%, and an approach to investment management which focuses primarily on security of capital and liquidity requirements.

8. INVESTMENT PROPERTY

8.1. Commercial property investment provides investors with:

- Higher income returns than equities, bonds or cash.
- Secure, regular income with income growth prospects to hedge against inflation.
- Capital value appreciation.
- Asset management opportunities to further increase rental and capital growth.
- Underlying real assets.
- Low correlation of investment performance with other asset classes.

8.2. However, as with any investment, there are associated risks:

- Illiquidity: property is a 'bricks and mortar' asset which takes time to sell/buy.

- Threats to income security if the tenancy fails and the property cannot be re-let.

- Capital depreciation: if the asset is not properly managed and left to fall into disrepair.

- High transaction and management/holding costs.

8.3. Geographically, the investment property portfolio is concentrated within the borough, which tends to concentrate the economic risk in one area. Currently, the property portfolio is heavily fragmented due to its historical incremental build-up, with a heavy concentration in car parks which generates 39% of total income, followed by shops generating 22%, offices generating 17% and other smaller units generating the remainder.

8.4. The car park assets, which provide a steady income stream, offer value added opportunities through potential change of use and redevelopment over time. The Council is focused on delivering best returns by both acquiring new assets and redeveloping existing assets, so improving the quality of the portfolio.

8.5. An annual £50m drawdown facility for investment schemes to generate additional income towards future Medium Term Plan savings was approved as part of the previous years' capital strategies (total £100m to date). Of this £28.1m has been invested, leaving an available balance of £71.9m. Schemes funded by this capital budget will go ahead after full diligence and should generate additional income.

8.6. Focus should be on optimising performance of the Council's portfolio and acquiring adjacent/adjoining assets which will also provide additional active asset management opportunities within the portfolio.

9. LONG-TERM INVESTMENTS

9.1. No general legal restrictions are placed on the value, length or nature of such investments and the only proviso is that investments are placed in accordance with investment strategies formally approved by members. The City Council's Treasury Management Strategy Statement (TMSS) expressly permits new investments in non-specified institutions. For any such investments, specific proposals will be considered by the Tri-Borough Director of Treasury and Pensions, and approved by the S151 Officer subject to due diligence.

9.2. The Council's current portfolio of non-specified investments is:

	Value at 31 March 2019 £ million	Value at 31 March 2018 £ million	Expected return
Investments in companies controlled or significantly influenced by the Council	27.5	27.5	Nil direct to the Council, profits made are usually reinvested in the business
LGA Loan	20.0	0	3.13%

Supranational	0.0	72.7	0.77%
Property Fund Partnership (Lettings Fund)	26.0	15.0	Annualised 3.13% over 7-year life of fund
Total	**73.5**	**115.2**	

10. FACTORS IN INCREASING YIELD

10.1. This has been partially achieved but the requirement for liquidity will remain paramount.

Change	Current situation	Risk	Progress made in 2018/19
Treasury Management			
1. Lengthen the maturity structure from the current average seven months to a target average maturity of two years	By investing in longer maturity assets with same credit quality, some additional yield may be generated, but the gilt yield curve is relatively flat, so yields would likely increase by about 0.3%.	Going out to longer dated bank deposits beyond 5 years would increase counterparty risk to individual banks, which becomes more of a risk if there is a future financial crisis	Steps have been taken to extend the average maturity periods, subject to the Council's cash flow requirements and resultant need for liquidity in the current financial year and beyond. At 31 March 2019, £145m worth of investments are locked for periods of six months to a year, with proposals in place to invest for periods of up to two years, preferably with local authorities.
2. Widen the credit quality of investments by moving from the current average rating of AA to A. This would allow the Council to invest a greater number of instruments with a moderate amount of credit risk (eg corporate bonds) that have maturity beyond one year. Yields tend to be higher to compensate for the higher perceived	For example, a portfolio of short duration investment grade sterling denominated credit benchmarked to the Barclays Sterling Corporate Bond index of 3 to 5 year maturities yields 1.24% currently, which is more than double the yield on the current treasury portfolio. The average credit rating of the index is BBB+/A	By diversifying away from bank deposits, although marginally lower credit rating, this would spread the risk in the event of a future financial crisis.	At 31 March 2019, the treasury investment portfolio had £45m invested in investments with credit ratings A, £125m in A+, £139.2m in AA-, £360.1m in AA counterparties and £59.7m in AAA rated counterparties. Any category of an A grading is known as investment grade and thus has high quality status.

Change	Current situation	Risk	Progress made in 2018/19
risk and reduced liquidity			
3. Add more credit sub-asset classes such as asset backed securities (ABS). These are typically listed rated bonds which can be traded, but liquidity varies depending on the issue. Types of credit include car loans, credit cards and residential mortgage backed securities (RMBSs)	Yields are in the range of 0.65% above the current treasury portfolio yields (AAA rated). Yields can be higher for AA or A rated asset backed securities.	The extra yield reflects the potential complexity of these instruments, but since the last financial crisis regulation has made asset backed securities more secure through risk retention rules, increased ratings scrutiny and credit protection, reflecting the government policy increasing lending to households and small businesses	Exploration has been made by officers with regard to investment in Asset Backed Securities (ABS). In the light of general economic/investment uncertainty created by the UK's pending departure from the European Union, this proposal is temporarily on hold.
Investment property			
4. Adopt a more focused property investment strategy by reducing the number of properties and increasing the lot size to efficiency gains and reduce the cost of management and maintenance. Given the added illiquidity of property investment, this only makes sense if the Council can achieve materially higher yields than the treasury portfolio and meet other objectives such as reducing risk (eg inflation) or help meet statutory duties. Therefore new acquisitions should target a total return of least 5%. A further objective is the acquisition of suitable properties which will assist in the unlocking or enhancement of regeneration schemes or the achievement of other strategic benefits (not necessarily	Increased return on property portfolio of at least 0.8%.	Adverse property markets may result in a fall in sale value	The Director of Corporate Finance and Property has continued the commercial property acquisition programme with various new properties added into the portfolio. The most recent purchases are 10-12 Orange Street for a purchase price of £11.8m and 14-20 Orange Street for a purchase price of £15m (total costs acquisition cost of £28.1m).

Change	Current situation	Risk	Progress made in 2018/19
financial) for the Council.			
5. Expanding the use of fund structures to deliver specialist functions such as supported living housing, homeless shelters, asylum housing etc. This would meet statutory duties and generate a return.	Yields from public social housing real estate investment trusts (REITs), such as the Real Lettings Fund which the Council is currently invested in are generating returns of 6%	By using a fund structure, this arms-length approach distances the Council from the costs of directly managing such property and investment is secured on the underlying property	During the implementation process, consideration will be given to additional transaction costs (which may be bid/offer on entry and exit), as well as high management fees and/or the underlying costs of such investments.
Alternative assets			
6. These fall outside traditional investments, such as listed equities and bonds, and include renewable energy, infrastructure and commodities.			Currently, these are considered too high risk for the treasury portfolio.
Pension Fund			
7. Pension Fund deficit: pay off entire deficit post 2019 actuarial valuation	This eliminate the interest payable on the pension fund deficit in its entirety, providing contribution and interest savings	Adverse markets in UK and abroad increase pensions deficit notwithstanding the payment made	The Council is proposing to pay all of its pension fund deficit identified in the 2019 triennial actuarial valuation, currently projected to be £151.5m, around 1 April 2020.

11. GOVERNANCE

11.1. The implementation, management, monitoring and reporting of the Investment Framework are delegated to officers in the same way that they are with the Treasury Management Strategy Statement (TMSS). Investment decisions that require such action are delegated to the Cabinet Member for Finance, Property and Regeneration after due diligence and advice from the Executive Director of Finance and Resources, Director of Corporate Finance and Property and Tri-Borough Director of Treasury and Pensions.

11.2. The implementation, monitoring and reporting is delegated to the Investment Executive, comprising:

- the Cabinet Member for Finance, Property and Regeneration and the Chairman of the Audit and Performance Committee;

- the Executive Director of Finance and Resources, the Director of Corporate Finance and Property and Tri-Borough Director of Treasury and Pensions.
- the Chief Executive as necessary.

11.3. The Investment Executive meets quarterly, supplemented with ad hoc calls and meetings in times of need of change.

11.4. Investment property and alternative asset allocation should focus on in-borough, with out-of-borough options being explored as and when they arise and subject to Cabinet Member approval.

11.5. With regard to investments in out-of-borough property developments, these should be considered individually and should outweigh the benefits of investing in-borough (which can have a number of non-commercial benefits, e.g., place making) and in a diversified property fund.

11.6. All Individual decisions should be subject to Cabinet Member approval.

If you have any queries about this Report or wish to inspect any of the Background Papers please contact:

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BACKGROUND PAPERS

Council

2018/19 Treasury Management Strategy Statement

2018/19 Investment Framework