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EAST RIDING OF YORKSHIRE COUNCIL

Report to: **Council**
07 February 2019

Wards:

All wards

Treasury Management Strategy 2019-20

Report of the Director of Corporate Resources

A. Executive Summary

Treasury Management is the management of the Council's cash flows, its 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.

Ministry of Housing, Communities and Local Government (MHCLG) guidance under the Local Government Act 2003 requires local authorities to set out their policies for managing investments for giving priority to the security and liquidity of those investments.

This strategy is drawn from the Council's Treasury Management Policy Statement and covers investments, borrowing, the outlook for interest rates, the management of associated risks and the policy to be adopted on Minimum Revenue Provision (MRP).

The Strategy was considered by the Audit Committee on 25 January 2019 and and the Cabinet on 29 January 2019, both of which recommended it be approved by full Council.

B. Corporate Priorities

Growing the Economy
Helping Children and Young People Achieve
Promoting Healthy Lifestyles
Protecting the Vulnerable
Valuing the Environment

C. Portfolio

Leader

D. Recommendation and Reason for Recommendation

The Council approve the Treasury Management Strategy and MRP policy for 2019-20, as set out in this report.

MHCLG guidance requires an annual investment strategy and an MRP policy to be approved by full Council before commencement of the financial year.

1. Background

1.1 Treasury Management is the management of the Council's cash flows, its 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.

1.2 The Council maintains and operates a Treasury Management Policy comprising the principles and practices to which the activity will comply. Alongside this policy, the Council must have regard to Ministry of Housing, Communities and Local Government (MHCLG) guidance, under section 15(1)(a) of the Local Government Act 2003. This guidance provides for each authority to determine its own controls within a given framework.

1.3 The Council's Treasury Management Policy is prepared in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Services. A revised code was published in December 2017 in response to moves by some local authorities into yield bearing non-financial investments, such as commercial property. The MHCLG also responded by updating its statutory guidance during February 2018.

2. Considerations including Options

2.1 This report considers the strategy to be followed during 2019-20, for investment and borrowing. It also sets out the Council's expectation for interest rates and highlights the uncertainties and risks in the forecast.

2.2 Furthermore, the report considers those aspects of treasury policy that change annually or more frequently, highlighting the Council's views or interpretation of factors that may influence treasury management decisions and proposes how these matters will be dealt with during 2019-20.

2.3 The revisions to the CIPFA Code and MHCLG statutory guidance require the authority to set out its approach to non-treasury investments and from 2019-20. This is detailed in the Council's Capital Strategy 2019-20 and a summary of the impact and the Council's approached is included in paragraph 4.10 and 4.11 of this report. The MHCLG also updated its guidance on the Minimum Revenue Provision (MRP) and this is discussed in paragraph 8.4.

2.4 The Council's Treasury Management Strategy is developed from and complies with the Council's Treasury Management Policy and takes account of the revised CIPFA code and MHCLG guidance referred to above.

3. Treasury Management Strategy

3.1 The prime objective of the Council's investment strategy is to maintain capital security whilst ensuring that there is the necessary liquidity to carry out its business. Within these constraints, the strategy aims to maximise returns.

3.2 The borrowing strategy aims to minimise both the revenue cost of debt and the potential volatility of these costs which can arise from changes to interest rates.

3.3 One revenue consequence of borrowing is the statutory requirement to set aside an amount for repayment of debt, known as Minimum Revenue Provision (MRP). Regulations require the authority to determine annually a principle by which MRP will be determined.

3.4 The Treasury Management Strategy aims to protect the Council from market-related risks by monitoring interest rates, economic indicators and UK and overseas government finances and reacting accordingly. A range of information sources are used to inform economic analysis and forecasts.

3.5 The following paragraphs represent the detailed strategy to be followed during 2019-20.

4. Investment

4.1 Except for speculative type investments (e.g. stock market), local authorities are free to invest money widely. The updated MHCLG guidance defined a new "loans" category of financial investment, in addition to the existing categories of "specified" and "non-specified" investments.

4.2 Loans are those investments made to wholly owned companies or associates, joint ventures, or to third parties as part of a wider strategy for local economic growth. Specified investments are those investments denominated in sterling, which are due or may be required to be repaid within 12 months of the date the transaction was made and the organisation or scheme with which the investment is made is of "high credit quality". Non-specified investments are all other investments.

4.3 The guidance leaves it to each local authority to determine what it considers "high credit quality". East Riding of Yorkshire Council demands security of capital as a prime objective. It is considered that those institutions with a long-term rating of A- or higher combined with a short-term rating of A2 or higher are commensurate with a low level of risk. These levels constitute the top three (of four) credit ratings considered to be "investment grade". An investment grade credit rating indicates the risk of default is low and is considered a benchmark of quality for investment managers. The fourth level of investment grade is also referred to as "speculative grade" as the investment would be vulnerable to changing economic conditions. Below this level ratings are classified as "junk" indicating the investment could quickly run into difficulties.

4.4 The Council does not rely on credit ratings alone. In addition to and complementing credit ratings, the use of credit default swap prices, real-time market data monitoring, and quality financial press are used to gain further market intelligence and determine those organisations of high credit quality. An extract from the Council's Treasury Management Policy is included at Appendix 1, which sets out the limits that apply to each counter party and the portfolio as a whole.

4.5 Non-specified investments are risk-assessed at the time an investment is made. Unquoted investments will not normally be made. The authority may enter into reverse repurchase agreements, provided they are based on the GMRA 2000 or 2011 (Global Master Repo Agreement) and the collateral is UK government debt including: Index linked gilts, Conventional gilts, UK Treasury bills or a pool of gilts referred to as DBV (Delivery By Value).

4.6 Loans will also be assessed on their merits at the time of investment, having regard to the counterparty, size and duration of the investment and how it will contribute to achieving the Council's strategic aims. The Council has one loan outstanding. The counterparty is Nite Direct Marketing Ltd, a wholly owned subsidiary and the loan is being repaid in equal monthly instalments until June 2024. The outstanding balance as at 31/12/2018 is £173,648.28.

4.7 Investment risk cannot be entirely eliminated but is managed through the credit and counterparty framework set out in the Treasury Management Policy.

4.8 The following restrictions to the investment criteria in the Treasury Management Policy remain in place:

- The maximum loan limit for specified investments is set at £10m and the maximum duration is twelve months.
- The limit on investments in AAA-rated money market mutual funds is set higher at £15m per fund, since those funds mirror the Council's policy objectives of security and liquidity.
- Most banks domiciled in the eurozone remain suspended in view of the ongoing sovereign debt issues and high levels of non-performing loans in the region. Where there is a group structure, consideration will not just be given to the domicile of the parent bank, the exact nature of this structure and how it is regulated will also be considered.
- Banks domiciled in the Middle East remain suspended in view of the ongoing conflict, political instability and civil unrest in the region.
- To enhance diversification, up to 10% of the investment portfolio may be invested in corporate bonds, restricted to those issued by specific counterparties agreed by the Operational Treasury Management Board (OTMB).

4.9 The OTMB is an officer group that meets on a bi-monthly basis and is chaired by the Chief Finance Officer. It considers operational treasury matters, monitors treasury risks and market conditions, and formally reviews and amends investment criteria within the Treasury Management Policy as appropriate. An OTMB member must authorise the daily investment and borrowing transactions confirming they are within the approved policy framework.

4.10 CIPFA's Code of Practice on Treasury Management in the Public Services requires the authority to set out its approach to non-financial and non-treasury investments. Non-financial investments are investments which are not held as a financial instrument, e.g. a property holding rather than a bond. Non-treasury investments are investments which are held for purposes other than treasury management (as defined in paragraph 1.1), e.g. to generate a long-term return. The Council's treasury management function does not invest in non-financial assets. The impact of the revisions require that non-treasury investment decisions are subjected to a rigorous risk assessment process, including option appraisal and scenario analysis, and that the reasons for these investment decisions are clearly explained. The Council does not currently hold any material non-treasury investments.

4.11 As with treasury investments, the Council will give priority to security and then liquidity over yield. The Council will ensure that the level of any related debt taken on and the aggregate risk is proportional to the size of the authority. It will also be clear about the contribution made from non-core investments towards core functions and disclose any dependence on commercial income to deliver statutory services. If the specialist expert knowledge required to evaluate and make the investment decision is not available within the Council, external advice and training will be sought. The detailed approach is set out in the Council's Capital Strategy 2019-20.

5. Borrowing

5.1 In general, the Council will borrow for one of two purposes – to finance cash flow in the short term or to fund capital investment over the longer term. It is not anticipated that it will be necessary to borrow for either of these purposes during 2019-20.

5.2 The Government intends that all supported capital expenditure will be grant funded. Additionally, capital investment plans provide for £26.9m of unsupported borrowing and there is at present an underlying need to borrow up to £110.0m to finance past capital expenditure. The current financial plan does not anticipate a need to externalise this borrowing during 2019-20.

5.3 The Council is able to borrow from the Public Works Loan Board, a statutory body, and would expect to be able to meet its needs from that source. However, loans are also available from the market and these will also be considered if the costs of such loans are favourable.

5.4 The Council's debt portfolio is managed to ensure that the maturity profile will not leave any one future year with a high level of repayments that could present difficulties in refinancing. In line with this, long term borrowing will generally be taken on the basis of equal instalment of principal or annuity, rather than maturity, thereby spreading repayments over future years. Fixed rate loans are usually taken to lock into known interest rates, thus protecting against fluctuations and providing certainty when managing and setting the budget.

5.5 The exception to this is borrowing in respect of the Housing Revenue Account (HRA); this is generally structured to match forecast cash flows within the HRA business plan.

5.6 Whilst the above deals with past or present borrowing requirements, it is also possible to borrow in advance of need. Current capital investment forecasts require funding from borrowing of £38.1m for the three years 2020 – 2023, however, projected levels of cash balances indicate that it will not be necessary to action this borrowing until the end of the period. Borrowing in advance of need introduces additional credit and interest risk. Whilst there is no present intention to borrow in advance, all risks will be considered as part of any borrowing decision, should conditions favour such action.

5.7 Furthermore, the portfolio is regularly reviewed to identify any refinancing opportunities. The current interest rate structure means this is not cost effective and it is unlikely that such an opportunity will present itself during 2019-20.

6. Interest Rates

6.1 There are many influences that affect money market sentiment and consideration is given to both short-term and long-term interest rates, which move and react differently and to differing factors. The relevant treasury management decisions taken in respect of the strategy will be influenced by the prevailing interest rates throughout the year.

6.2 The Bank of England's (BoE) Monetary Policy Committee (MPC) is charged with setting UK official bank rate in order to achieve a consumer price index (CPI) inflation target of 2%. For short term rates, money markets are normally guided by bank rate, or more precisely the level, direction and timing of bank rate changes. In other words, money markets try to predict what the MPC will do in the future.

6.3 In August 2018, the MPC increased bank rate for the second time in over a decade. This was in response to the resilience of the UK economy, despite the uncertainty of Brexit, and forecasts of building domestic inflationary pressures as the UK labour market tightens and wages rise. Bank rate now stands at 0.75% and the BoE has maintained its programme of asset purchases using 'new' money, a process known as quantitative easing (QE), at £435bn. The MPC continued with its guidance that when bank rate does begin to rise, it would do so gradually and depend on economic developments. For the first time it published an estimate of the equilibrium rate of interest at which the UK economy could grow sustainably with both full employment and inflation. This level of between 2-3% is materially below the 5% average level prior to the financial crisis. Markets expect three quarter point rate increases over the next three years, with a 56% chance of the next rise in November 2019. The current forecasts indicate bank rate will be 1.25% in the latter part of 2020, reaching 1.5% during 2021.

6.4 Weaker sterling exchange rates, higher energy prices and wage growth held the pace of UK CPI above the 2% target during 2018. Inflation slowed from 3% at the start of 2018 to 2.4% in October 2018. CPI is forecast to fall to around 2.1% during 2019 as the effects of higher energy and import prices fade. The BoE believes the pace at which the UK economy can grow without generating inflationary pressure has fallen over recent years and estimates this to be 1.5%. The BoE's forecasts are based on a smooth transition to new trading arrangments following the UK's departure from the EU in March 2019 and anticipate economic growth just above this level.

6.5 There is heightened uncertainty surrounding exact nature of Brexit and its impact on the UK economy. BoE officials have stated various possible effects on the UK economy including slower growth or recession and higher inflation fuelled by a weaker pound and rising wages. The MPC could decide to raise rates more quickly than forecast to curb inflation, alternatively it may prioritise loosening monetary policy to support faltering economic growth. Additional headwinds to economic growth include the ongoing trade war between the US and China and slowing emerging markets as developed economies tighten monetary policy.

6.6 Longer-term rates are set by reference to bond yields, which concentrate on perceived success in inflation management. Government bond yields move with expectations of ability and willingness to control inflation but are also influenced by the supply of bonds. The planned net annual gross gilt issuance for 2019-20 has returned to pre-crisis levels. However, gross annual gilt issuance remains around three times the normal level as the Government manages the post-crisis legacy of a much larger portfolio of outstanding debt. During 2019, the UK continued to benefit from historically low central bank rates in developed markets and, despite Brexit uncertainties, 'safe haven' status as investors responded to geopolitical tensions. The BoE's QE programme and resilient economic growth, have also maintained demand for gilts keeping yields low.

6.7 The progress of Brexit negotiations and the new trade arrangements will impact on market sentiment for UK-based investment. A reduction of confidence in the strength of the UK economy could lead to gilts losing their safe-haven status and rising public borrowing costs.

6.8 Notwithstanding the Council's cash flow requirements, market expectations of interest rates will influence the duration structure of the Council's short term investment portfolio, i.e. a higher level of volatility and uncertainty in the financial markets may reduce the duration of new investments. This approach, combined with the investment strategy described in section 4 and the management of risk described in section 7, acts to maintain the security of the Council's investments whilst providing the necessary liquidity to meet the Council's operational cash requirements.

6.9 Public Works Loan Board (PWLB) interest rates are priced around 0.8% above gilts. Twenty-five year rates have moved between 2.40% and 2.86% during 2018-19, with 50-year rates moving between 2.70% and 3.13%. Expectations are that the range of movement during 2019-20 will be between 3.00% and 4.50%.

6.10 Currently, projected levels of cash balances indicate that it will not be necessary for the Council to borrow until after 2020-21, but this will be re-considered if cash balances were to fall to a level where borrowing is deemed necessary or a significant increase to borrowing rates is forecast. Active consideration will be given to long-term borrowing if a 'trigger point' of 4.50% for the 25-year PWLB rate is reached.

7. Management of Risk

7.1 Credit and counterparty risk and market risk (the risks associated with the core principles of security, liquidity and yield) are managed within and monitored against the framework approved in the Treasury Management Policy.

7.2 Investment is mainly by cash deposits with financial institutions. However, in order to increase diversification, it is possible to purchase financial assets issued by banks, non-financial companies, sovereigns and sub-sovereign organisations. These assets, such as Certificates of Deposit and bonds, are bought with a view to accessing counterparties not normally available to the Council.

7.3 Limited use of derivatives to manage risk appears to be permitted by the Localism Act 2011 and the latest CIPFA Code of Practice on Treasury Management. However, Government has been silent on this matter and it is likely that it will be left for the courts to determine. Consequently, the use of derivatives will not be considered until the situation becomes clarified.

7.4 The OTMB continues to meet bi-monthly, chaired by the Head of Finance, to consider issues of best practice, market conditions and intelligence and formally review the restrictions in place over investment and borrowing within the limits set out in the Treasury Management Policy.

7.5 Financial counterparties have historically classified the Council as a professional investor. Under the European Union's new Markets in Financial Instruments Directive II (MiFID II) directive all UK local authorities were reclassified as retail investors from 3 January 2018. This is aimed at protecting smaller councils with little or no investment expertise by reducing the range of investment options available to them and increasing regulatory protections. The regulation provides an option for a Council with larger treasury management functions to request re-classification as an elective professional investor, subject to demonstrating it has significant experience and knowledge.

7.6 Each financial entity has to interpret and apply the new MiFID II rules. Various money market brokers and large international banks confirmed they would not provide their services to retail investors and would terminate existing relationships. This included deposit taking which is an activity outside the scope of the new rules. The Council has considerable experience and knowledge of the risks involved in investing in a range of financial instruments and as such would not be exposed to unmanageable risk as a result of the non-application of regulatory protections offered to retail investors. The Treasury Management Policy permits the Council to request re-classification as an elective professional investor, should a financial counterparty require this, to ensure the effective functioning of its treasury management activities.

8. MRP Statement

8.1 A revenue consequence of borrowing is the statutory requirement to set aside an amount for the repayment of debt, known as Minimum Revenue Provision (MRP). Regulations require the authority to annually determine a principle by which MRP will be determined.

8.2 MHCLG guidance requires that before the start of each financial year a local authority prepares a statement of its policy on making MRP in respect of that year and submits it to the full Council.

8.3 The 2008 regulations require the amount of MRP charged to be a prudent amount. The broad aim of prudent provision is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government funding, reasonably commensurate with the period implicit in the determination of that funding.

8.4 The revised MHCLG guidance published in 2018 states the maximum useful life of an asset should not normally exceed 50 years when calculating MRP using an asset life method. However, where a local authority has an opinion from an appropriately qualified professional advisor that an asset will deliver service functionality for more than 50 years, it can use the life suggested by its professional advisor. The asset lives used by the Council to calculate MRP are those recorded in its asset register and have been provided by professional advisors thus meeting the requirement. For a lease or PFI asset, the length of the contract should be used.

8.5 It is recommended that the Council continues to apply the following policy to determine its MRP for 2019-20:

- The asset life method is to be used to calculate MRP for the remaining Capital Financing Requirement relating to capital expenditure incurred before 1 April 2007. An average asset life of 51 years has been determined for the pre-2007/08 assets on the Balance Sheet.

- The asset life method is to be used to calculate MRP for all General Fund capital expenditure incurred from 1 April 2007, with the asset life determined from the outset and MRP charged in the year following the one in which the expenditure is incurred, with the exception of:
  - a) Where expenditure is incurred over more than one year, then the asset life and MRP shall commence in the year the asset becomes operational in accordance with proper accounting practice,
  - b) Deemed capital expenditure financed by borrowing which will have an asset life as prescribed in the guidance, and
  - c) Finance leases and PFI assets which will have a life determined by the life of the financial instrument as a proxy for asset life. Use of the financial instrument life to determine MRP is similar to the prescribed life in respect of deemed capital and associates the charge to revenue with cash flows.

- For HRA capital expenditure, there is no requirement to set aside MRP or to repay debt. Consequently, the HRA will periodically set aside voluntarily an amount considered affordable within its business plan.

9. Conclusion

9.1 Financial markets are subject to a period of historically low interest rates, enhanced scrutiny and changing regulation, and investment yields are low. In light of this and given the prime objective of capital security, the restrictions on lending identified in paragraph 4.8 will continue but will be subject to regular review by the OTMB.

9.2 For borrowing, a 'trigger point' of 4.50% will be used, being the 25-year PWLB rate at which active consideration will be given to borrow longer term. Whilst borrowing above that level may be considered, the Council is not in a position where it needs to borrow at any cost.

9.3 The determination of the MRP policy set out in section 8 offers the Council maximum flexibility in its charge to revenue.

9.4 The Council's Treasury Management Policy is regularly reviewed to ensure that it continues to reflect the Council's risk appetite and best practice.

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Background Papers
Treasury Management Policy
MHCLG Investment Guidance
MHCLG MRP Guidance
CIPFA Prudential Code

Appendix 1

EXTRACT FROM THE TREASURY MANAGEMENT POLICY

Credit and Counterparty Risk Management

For specified investments, an institution or instrument must be rated by at least two of the three reference agencies and, if these are different, the lowest rating will apply.

Credit ratings are 'live' and therefore subject to change. New ratings may be issued and existing ratings may go up or down. As such it is not appropriate to include in this statement a list of counterparties meeting the above criteria since it would only be valid at a point in time, although in practice a list is maintained.

Similarly, non-specified investments will be assessed on their merits at the time of investment, having regard to the counterparty, size and duration of the investment, which will not exceed five years. The aggregate of non-specified investments is limited to £30 million at any one time.

Loans will also be assessed on their merits at the time of investment, having regard to the counterparty, size and duration of the investment and how it will contribute to achieving the Council's strategic aims. The term of a loan will not exceed 20 years. The aggregate of loans is limited to £30m at any one time.

To further embed diversification, a maximum of 10% of the portfolio will be invested with an individual institution (15% limit applied to a group). In addition to these limits, no more than 25% of the Portfolio may be placed in each of the regions – North America including Canada; Middle East; Asia; Australia and New Zealand and non-UK Europe. Non-UK institutions are determined by ultimate ownership (parent company) where part of a group. Since money market mutual funds themselves dilute risk, a maximum of 20% of the portfolio may be placed with a single fund.

Applying the principles detailed above provides the following framework, within which counterparties and investment transactions will be made.

	Maximum Limit
1. Specified Investments *(limit per counterparty)* [1]	
UK Government	Unlimited
Local Authorities	£20.0m
Money Market Funds with a minimum rating AAA[2]	£20.0m
Institutions with a minimum rating of AAA/A1[2]	£20.0m
Institutions with a minimum rating of AA-/A2[2]	£15.0m
Institutions with a minimum rating of A-/A2[2]	£10.0m
Building Societies – assets greater than £5,000 million[2]	£5.0m
Building Societies – assets greater than £1,000 million[2]	£2.5m
Building Societies – assets greater than £250 million[2]	£1.0m
2. Non-specified Investments *(limit per counterparty)*	
Investments for more than 365 days	£5.0m
Other non-specified investments	£5.0m

3. Loans *(limit per counterparty)*	
Other Public Bodies	£15.0m
Wholly owned companies or associates	£15.0m
Partnership Arrangements	£15.0m
4. Other Limits *(on day of investment)*	
Percentage of portfolio with a single institution	10.0%
Percentage of portfolio with a group with common ownership	15.0%
Percentage of portfolio within UK Europe	Unlimited
Percentage of portfolio within each geographic region	25.0%
Percentage of portfolio with a single fund	20.0%
Aggregate value of Non-specified Investments	£30.0m
Aggregate value of Loans	£30.0m

Notes: [1] Ratings shown are Standard and Poor's; comparable ratings are used by Moody's and Fitch rating agencies.

[2] Ratings and limits are for guidance only, other information will also be taken into account, (eg. Credit default swap prices), in determining whether to use a counterparty.