

EAST RIDING OF YORKSHIRE COUNCIL

Report to: Council
11 February 2021

Wards: All

Treasury Management Strategy 2021-22

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 22 January 2021 and the Cabinet on 2 February 2021, 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

The Council approves the Treasury Management Strategy and MRP policy for 2021-22, 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.

E. Equality Implications

Equality implications have been considered and no negative impacts upon protected characteristic groups were identified.

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.

2. Considerations including Options

- 2.1 This report considers the strategy to be followed during 2021-22, for investment and borrowing. It also sets out the Council's expectation for interest rates and highlights the uncertainties and risks in the forecast due to market conditions.
- 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 2021-22.
- 2.3 The CIPFA Code and MHCLG statutory guidance require the authority to set out its approach to non-treasury investments. This is detailed in the Council's Capital Strategy 2021-22 and a summary of the impact and the Council's approach is included in paragraph 4.10 and 4.11 of this report.
- 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 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 2021-22.

4. Investment

- 4.1 Except for speculative type investments (e.g. stock market), local authorities are free to invest money widely. The MHCLG guidance defines three types of investment, these are loans, specified investments 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 to be "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 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. During 2021-22, the Council will continue to pursue opportunities to increase the diversification of risk in its investment portfolio while optimising returns.

- 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 two loans outstanding which are detailed below:
- The first counterparty is Nite Direct Marketing Ltd, a wholly owned subsidiary of the Council. The outstanding balance on the loan, as at 31 December 2020, is £142,105.32. The loan is being repaid in equal monthly instalments until it is fully repaid, due June 2024.
 - The second counterparty is the Help for Health charity. The outstanding balance on the loan, as at 31 December 2020, is £100,000.00 and is due to be repaid in full by 31 December 2021.
- 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 Council's Operational Treasury Management Board (OTMB) also considers risks within Treasury Management operations. 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.
- 4.9 During 2020-21, the OTMB has made no changes to the policy framework. The OTMB has continuously reviewed the heightened risk environment and current low interest rates available and the impact on the Council's investment returns. Options to increase the return on investments whilst adhering to the Treasury Management Policy continue to be explored. 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.
 - 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 and political instability 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).
- 4.10 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. In accordance with guidance, any non-treasury investment decisions are subjected to a rigorous risk assessment process, including option appraisal and scenario analysis, and 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.

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 2021-22.

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 in 2021-22 and there is at present an underlying need to borrow up to £45m to finance approved capital expenditure. The current financial plan does not anticipate a need to externalise this borrowing during 2021-22.

5.3 The Council is able to borrow from the Public Works Loan Board (PWLB), a lending facility for local authorities operated by the UK Debt Management Office on behalf of HM Treasury, 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. In response to concerns over “debt for yield” activity, whereby a minority of local authorities were using low cost loans to buy investment property primarily for rental yield, HM Treasury launched a consultation to work with local authorities, sector representatives, and wider stakeholders to develop a targeted intervention to stop this kind of activity while protecting the crucial work that local government does on service delivery, housing, and regeneration.

5.4 Following the consultation and in response to the low rate environment due to current market conditions, the Government published revised lending terms for accessing the PWLB. Crucially, the PWLB will not lend to any local authority that plans to buy investment assets primarily for yield anywhere in their capital plans, regardless of whether the transaction would be financed from a source other than PWLB.

5.5 The new terms apply to all loans arranged with the PWLB from 26 November 2020. The key points to note are as follows:

- The PWLB rate was reduced by 1% for all new Standard Rate and Certainty Rate loans - this reverses the 1% increase imposed in October 2019.
- As a condition to access borrowing from the PWLB, local authorities are required to submit a high level description of capital spending for 3 years.
- The local authority's Section 151 Officer must confirm that there is no intention to buy investment assets primarily for yield at anytime in the next 3 years.

5.6 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.

- 5.7 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.
- 5.8 Whilst the above deals with past or present borrowing requirements, it is also possible to borrow in advance of need where there is a clear business case for doing so and only for the approved capital programme or to finance future debt maturities, as permitted by the guidance. Current forecasts estimate funding from borrowing of £41.5m for the two years from 2022 for capital investment purposes, however, projected levels of cash balances indicate that it will not be necessary to action this borrowing until towards the end of the four-year financial planning period in 2024-25. 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.
- 5.9 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 2021-22.

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 monetary policy, including the UK official bank rate, in order to achieve a consumer price index (CPI) inflation target of 2% and in a way that helps sustain growth and employment.
- 6.3 Short term investment rates in money markets are normally guided by the 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.
- 6.4 In March 2020, the MPC reduced the bank rate to 0.10% from 0.75%. This was in response to the impact of the Coronavirus pandemic on economic activity. At the most recent meeting of the MPC, on 17 December 2020, it was unanimously agreed to maintain the rate at this level.
- 6.5 The ongoing impact of the pandemic is expected to mean that the bank rate will not change for some time. Although there has been some good news with vaccines becoming available much sooner than expected, the emergence of a much more contagious variant of the virus precipitated the introduction of a fourth "stay at home" tier, followed swiftly by a 3rd national lockdown. These actions have tightened restrictions and reduced permissible business activity. It is clear that the Government will need to see tangible evidence of the spread of the virus reducing considerably, before these restrictions will be lifted.
- 6.6 The uncertainty surrounding the UK's exit from the EU has reduced to some extent, following the Government negotiating an eleventh hour deal with the European Union. It remains to be seen how the new relationship with the EU will work, and the extent to which businesses will be positively or negatively impacted.
- 6.7 The UK's Gross Domestic Product (GDP), a measure of the size and health of the economy, is forecast to fall by 11% in 2020. The Office for National Statistics will release the initial estimate, for the 2020 year, around the middle of February. Although a recovery is anticipated, the economy is not expected to reach its pre-Coronavirus level until around the end of 2022. CPI is

forecast to be below 1% for 2020 and is not expected to reach the 2% target until 2025. These forecasts reinforce the view that the bank rate will remain at its current level for the foreseeable future.

- 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 At the start of 2020-21, Public Works Loan Board (PWLB) interest rates were priced at an average rate of 2.48%. Due to the rate decrease in November, outlined earlier in paragraph 5.3, the average rate currently is circa 1.40%. Twenty-five year rates have moved between 1.39% and 2.70% during 2020-21, with 50-year rates moving between 1.73% and 3.07%.
- 6.10 Currently, projected levels of cash balances indicate that it will not be necessary for the Council to borrow until after 2023-24, 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 3.50% 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 Investment may be made in pooled investment funds such as money market funds or other regulated UCITS (Undertakings for the Collective Investment in Transferable Securities) funds. These are professionally managed funds which can provide greater levels of diversification than are available to the Council as an individual investor. During 2021-22, the Council will be looking at the enhanced diversification and returns that are offered by such funds.
- 7.4 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.
- 7.5 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.
- 7.6 The Treasury Management Policy permits the Council to request re-classification as an elective professional investor under the Markets in Financial Instruments Directive II (MiFID II) directive, should a financial counterparty require this, to ensure the effective functioning of its treasury management activities. The Council has considerable experience and knowledge of the

risks involved in investing in a range of financial instruments and as such is not exposed to unmanageable risk as a result of the non-application of regulatory protections offered to retail investors.

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 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 2021-22:
- 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 currently subject to a suppressed interest rate environment on returns due to the combined impact of the UK's Exit from the EU and the Coronavirus pandemic. This has resulted in historically low interest rates, therefore investment yields are low. In light of this and given the prime objective of capital security, the restrictions on lending identified in paragraph 4.9 will continue but will be subject to regular review by the OTMB. However, the Council will continue to explore opportunities to increase the diversification of risk in its investment portfolio whilst optimising returns.
- 9.2 For borrowing, a 'trigger point' of 3.50% 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

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

3. Loans (*limit per counterparty*)

Other Public Bodies and educational establishments	£5.0m
Wholly owned companies or associates	£10.0m
Partnership Arrangements	£10.0m
Charities	£0.5m

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	£15.0m

Notes: ¹Ratings 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.