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EAST RIDING OF YORKSHIRE COUNCIL

Report to: Audit Committee
21 January 2022

Wards: All

Treasury Management Strategy 2022-23

Report of the Director of Corporate Resources

A. Executive Summary

This report sets out the Council's proposed Treasury Management Strategy for 2022-23. The report will be considered by The Cabinet on 1 February 2022. In view of the timing of respective meeting dates, any comments or recommendations of the Audit Committee will be reported orally at that meeting.

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

It is recommended that:

a) The Committee considers the Treasury Management Strategy for 2022-23.

b) Subject to any amendments, the Committee recommends the Strategy to The Cabinet for subsequent approval by full Council.

E. Equality Implications

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

1. Background

1.1 Article twelve of the Council's Constitution requires the Head of Finance, as Chief Finance Officer, to secure effective arrangements for treasury management.

1.2 The CIPFA treasury management code requires a responsible body to be responsible for ensuring effective scrutiny of the treasury management strategy and policies. The Council's nominated body to undertake this role is the Audit Committee.

1.3 The Treasury Managment Policy contains principles and practices which identify the parameters within which the treasury function can be operated. It identifies the risks associated with the function and specifies how those risks will be managed operationally on a day to day basis. Within this policy framework, the Treasury Management Strategy sets out the Council's overall approach to managing the risks associated with its investment and borrowing activities.

2. Considerations including Options

2.1 This report details the Council's proposed Treasury Management Strategy for 2022-23. In accordance with its Terms of Reference set out in the Council's Constitution, the Audit Committee is asked to review the Treasury Management Strategy.

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 Council 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 2022-23.

4. Investment

4.1 Except for speculative type investments (e.g. stock market), local authorities are free to invest money widely. The Department for Levelling Up, Housing and Communities (DLUHC) 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 real-time market data monitoring, and quality financial press are used to gain further market intelligence and determine those organisations of high credit quality. Non-specified investments are risk-assessed at the time an investment is made.

4.5 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 with Nite Direct Marketing Ltd, a wholly owned subsidiary of the Council. The outstanding balance on the loan, as at 31 December 2021, is £71,052.66. The loan is being repaid in equal monthly instalments until it is fully repaid by June 2024.

4.6 Investment risk cannot be entirely eliminated but is managed through the credit and counterparty framework set out in the Treasury Management Policy. An extract from the Council’s reivsed 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.

4.7 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.

4.8 The OTMB are proposing multiple changes to the policy framework which will come into effect from 2022-23 pending approval at the February Council meeting where it will be considered alongside this report. The OTMB has carried out a review of policy limits, and taken the opportunity to review limts in place across the Council and Pension Fund. The review has identified that policy limits have not been adjusted to keep pace with the significantly higher levels of cash being held on a consistent basis compared with that experienced when policy limits were initially set many years ago. The proposed changes will produce a uniform policy shared by both the Council and Pension Fund.

4.9 Furthermore, 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 enhance diversification, increase the return on investments whilst adhering to the Treasury Management Policy have continued to be explored. The Council has obtained professional advice from MJ Hudson, a firm of independent investment advisers who have identified two suitable pooled investment funds. Proposed changes to the policy limits will enhance diversification and enable an increase in investment returns.

4.10 Pending approval, the proposed changes to the Treasury Management Policy will take effect from 1 April 2022.

4.11 The following restriction to the investment criteria in the Treasury Management Policy will remain in place in order to meet the prime objective of capital security:

- Banks domiciled in the Middle East are suspended from investment, in view of the ongoing conflict and political instability in the region.

4.12 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.

4.13 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 2022-23.

5.2 The Government intends that all supported capital expenditure will be grant funded. Additionally, capital investment plans provide for £28.3m of unsupported borrowing in 2021-22 and there is, at present, an underlying need to borrow up to £68.3m to finance approved capital expenditure. The current financial plan does not anticipate a need to externalise this borrowing during 2022-23.

5.3 The Council is able to borrow from the Public Works Loan Board (PWLB), a lending facility for local authorites 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 which came into effect from 26 November 2020. The main terms include that 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. The Section 151 Officer must confirm that there is no intention to buy investment assets primarily for yield at anytime in the next 3 years and must submit a high level description of the capital expenditure for this period.

5.5 CIPFA subsequently issued a consultation on the Prudential Code and released the revised code on 20 December 2021, with soft guidelines to be undertaken from 2022-23. The changes take full effect from 2023-24. The tightened code will sit alongside the above measures taken by central government to reduce the risks taken by some local authorities in their investment activity. The revised code creates three categories of investments, where all investments and investment income must be attributed to the following purposes:

- **Treasury management**
  Arising from the organisation's cash flows or treasury risk management activity, this type of investment represents balances which are only held until the cash is required for use. Treasury investments may also arise from other treasury risk management activity which seeks to prudently manage the risks, costs or income relating to existing or forecast debt or treasury investments.

- **Service delivery**
  Investments held primarily and directly for the delivery of public services including housing, regeneration and local infrastructure. Returns on this category of investment which are funded by borrowing are permitted only in cases where the income is "either related to the financial viability of the project in question or otherwise incidental to the primary purpose".

- **Commercial return**
  Investments held primarily for financial return with no treasury management or direct service provision purpose. Risks on such investments should be proportionate to council's financial capacity – i.e. that 'plausible losses' could be absorbed in budgets or reserves without unmanageable detriment to local services. An authority must not borrow to invest primarily for financial return.

5.6 Local authority investments (including commercial property) may be categorised in accordance with the **primary purpose** of the investment, requiring chief finance officers to make a judgement as to the primary purpose of investments.

5.7 The revised code states that authorities "must not borrow to invest primarily for financial return". It also says that it is not prudent for them to make any investment or spending decision that could increase the need for borrowing, unless related to the functions of the authority and where financial returns are "either related to the financial viability of the project in question or otherwise incidental to the primary purpose".

5.8 Authorities which have an expected need to borrow should review options for exiting their financial investments for commercial purposes, and summarise the review in their annual treasury management or investment strategies. The options should include using the sale proceeds to repay debt or reduce new borrowing requirements. The reviews should evaluate whether to meet planned borrowing needs by taking new borrowing or by repaying investments, based on a financial appraisal which takes account of financial implications and risk reduction benefits. To avoid confusion, CIPFA have clarified in the revised code that authorities with existing commercial investments (including property) are not required to sell those investments.

5.9 CIPFA have confirmed that the revised code does not introduce any new restrictions on councils borrowing for purposes core to their core aims, such as for housing and regeneration projects, or for treasury management purposes.

5.10 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.

5.11 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.

5.12 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 £23.1m in 2022/23 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.

5.13 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 2022-23.

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 to a number of factors. The relevant treasury management decisions taken in respect of the strategy will be influenced by the prevailing interest rates and interest rate forecasts 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% in response to the impact of the Coronvirus pandemic on economic activity. On 15th December 2021, the Bank of England agreed to increase the rate to 0.25%, by a majority vote of 8 to 1.

6.5 Inflation has been creeping up throughout 2021 and there is an ongoing debate on whether we are seeing a transitory period of above target inflation or the start of something which will persist for longer. On one hand there are temporary supply and demand issues, with supply chains supressed by the pandemic impacting on staffing levels, as well as increased demand for goods as ecomonies recover in a low borrowing rate environment. On the other hand there are significant increases in wage costs in some areas due to labour shortages, and more generally in response to the increased cost of living. The majority of economist opinions are for inflation to be transitory, but the risk of sustained higher inflation is significant.

6.6 The headline messages from the MPC are to expect inflation to rise to around 6% in the Spring before falling back. If there is an increased likelihood of higher inflation for longer, this would be expected to lead to steeper interest rate rises.

6.7 The uncertainty surrounding the UK's exit from the EU has reduced to some extent but 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.

6.8 The UK's Gross Domestic Product (GDP), a measure of the size and health of the economy, fell by 9.9% in 2020, and is forecast to rise by 7.1% in 2021 and 5.2% in 2022. Recovery to pre-pandemic levels is therefore expected to be reached around the middle of 2022.

6.9 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.

6.10 At the start of 2021-22, Public Works Loan Board (PWLB) interest rates were priced at an average rate of 2%. The average rate currently is circa 1.91%. Twenty-five year rates have moved between 1.75% and 2.40% during 2021-22, with 50-year rates moving between 1.94% and 2.57%.

6.11 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 2022-23, the Council will be contining to enhance the 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 DLUHC 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 DLUHC 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 2022-23:

- 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 remain subject to a suppressed interest rate environment on returns due to the combined impact of the UK's Exit from the EU and the Coronovirus pandemic. The Bank of England base rate rise in December 2021 to 0.25% shows an increase in the interest rate environment, with expectations of the base rate rising further in the upcoming year. In light of this and given the prime objective of capital security, the restrictions on lending identified in paragraph 4.11 will continue but will be subject to regular review by the OTMB. The Council will continue to explore opportunities to increase the diversification of risk in its investment portfolio whilst optimising returns.

9.2 The changes to the Prudential Code will be monitored and implemented in preparation for 2023-24.

9.3 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.

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

9.5 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 DLUHC Investment Guidance DLUHC 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 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 £50 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 £20m at any one time.

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)*	
UK Government	Unlimited
Nat West	£30.0m
Local Authorities	£20.0m
Money Market Funds with a minimum rating AAA[2]	£20.0m
Banks and Building Societies with a minimum rating of A-/A2[2]	£20.0m
2. Non-specified Investments *(limit per counterparty)*	
All non-specified investments	£20.0m
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)*	
Aggregate value of Non-specified Investments	£50.0m
Aggregate value of Loans	£20.0m

Notes: [1]Ratings and limits are for guidance only, other information will also be taken into account in determining whether to use a counterparty.