NORTH YORKSHIRE COUNTY COUNCIL

EXECUTIVE

15 August 2017

INVESTMENT

REPORT OF THE CORPORATE DIRECTOR, STRATEGIC RESOURCES

1. PURPOSE OF THE REPORT

1.1 The current financial environment and low bank base rate (BRR) means that the Council is getting incredibly low returns on traditional investments. This report therefore proposes an alternative strategic approach to managing cash resources (in accordance with and to complement the Council's Treasury Management Strategy) in order to improve treasury returns, achieve revenue savings and potentially support the Council's wider objectives.

1.2 In summary the report aims:

i. To agree an approach to identify, assess and implement longer term (5 years plus) investment decisions including an element that targets commercial returns (i.e. net income for the Council; not service improvements and / or policy decisions);
ii. To establish governance to supplement existing decision making arrangements; and
iii. To deploy £10m from Balances that has been set-aside for debt reduction with a view to reducing some longer term revenue spending.

2. INITIAL OPTIONS AND PRIORITISATION

2.1 The opportunities for investment fall into 2 broad categories:

- Treasury Management – these opportunities are concerned with the use of resources within the Council, allowing resources to be earmarked or set aside to achieve revenue savings within the context of the Council's existing Treasury management Strategy. For completeness, opportunities which involve extension of the institutions and/or cash investment vehicles available to the Council will also be explored.
- Investment Projects – these opportunities are associated with the potential to invest in projects and initiatives delivered either directly by the Council or by/with partners in order to achieve a payback of the investment and an added return.

Individual ideas that have been considered in outline, along with an indication of their potential returns are set out at **Appendix A**.

2.2 In order to frame our thinking and to help prioritise the variety of options, an assessment of the relative risks and rewards has been undertaken. This assessment began with the identification of the risk and reward drivers we would need to consider when making decisions on how to invest the Council's funds. These drivers were then assessed against each other to derive a relative weighting for each. The outcome of this initial exercise produced the following weightings:

Risk Drivers	Weighting	Reward Drivers	Weighting
Missed alternative	2	Delivers wider corporate benefits	0
Reputational risk	17	Delivers wider economic growth	5
Interest rate risk	10	Cash return	14
Liquidity risk	8	Revenue saving	8
Capital loss	29	Capital gain	2
Failure to achieve objectives	18		
Potential for additional capital	4		
Partnership risk	7		
Administrative burden	1		

In this assessment the risk of capital loss is of greatest concern and the risk of an administrative burden is of least concern; whilst the reward of a cash return is most beneficial and delivery of wider corporate benefits is of no consequence in the context of the other rewards on offer.

2.3 Each investment option was then assessed for the degree to which they would present each risk and reward. The resulting scores were then plotted on a chart to illustrate the relative risk and reward to the Council of each investment opportunity. The risk/reward chart is shown at **Appendix C**. Each bubble on the chart represents a different investment opportunity with the size of the bubble illustrating the potential level of investment to be made.

2.4 From the initial assessment the opportunity with the highest risk and reward is lending to businesses whilst conversely replacing borrowing approvals with direct revenue financing presents the lowest risk and reward.

2.5 In order to take this work forward, high risk and low reward options are discounted at this stage, as are the lowest and highest risk/reward options, on the basis that there are other options which provide a better balance of risk and reward subject to the level of funds invested. The bubbles within the shaded area on the chart are explored in more detail in the section 5 below.

2.6 It should be stressed at this stage this assessment does not determine the likely level of returns to be made, it simply allows a broad judgement from which more detailed assessment is required and clearly not all of the investments can be taken forward with the funds available. Furthermore it is proposed that risk and reward appetite be set by and revisited at least annually by the Board established to oversee this work.

3. POTENTIAL INVESTMENT FUNDS

3.1 The funds earmarked for alternative investment are currently £10m. Whilst £10m represents a significant sum, the on-going need for revenue savings presents an opportunity to consider the potential for extending the level of investment by applying a longer term approach to managing the Council's cash resources. The Council's current investment portfolio is circa £240m (excluding external bodies) so there is opportunity to consider alternative investments on a larger scale to improve the overall investment returns for the Council within the context of the overarching Treasury Management Strategy.

3.2 Latest treasury returns are an average of 0.6% - generating a revenue income of £1.4m for the Council. Each 0.1% improvement on this rate would generate an additional £140k p.a.

3.3 The amount of funds available for alternative investment is dependent upon the amount of cash the Council has over the longer term. Long term cash flow modelling, applying assumptions on funding and spending, shows that over the next 20 years there is a core cash sum that could be invested over a longer period.

3.4 Ignoring funds held on behalf of external bodies, the Council's available cash balances are forecast to drop to £83m over the next 4 years and subject to decisions on capital spending they are then expected to rise to over £100m over the next 20 years.

3.5 These resources are earmarked for specific use – for example to support directorate spending plans or repay debt, but in the meantime are available for investment until the point at which they are needed.

3.6 In order to ensure sufficient funds to manage the Council's cash flow it is proposed that up to £50m (which represents approximately 20% the current investment portfolio) is considered for alternative investment aiming for a range of investment periods from 1 to 20 years to enable appropriate liquidity of funds (i.e. the ability to release the cash invested).

4. ESTABLISHING A FRAMEWORK FOR ASSESSING INVESTMENT OPPORTUNITIES

4.1 The options available to the Council are varied and individual investments will in most cases require a business case. However limits on the sums invested and targets for investment returns will ensure a diverse portfolio, appropriate churn of cash and an appropriate balance between risk and reward.

4.2 In order to establish a high level decision framework to complement the process outlined in section 2, the following are proposed based on current interest rates:

Type of investment	Risk	Maximum Exposure £000	Maximum Term Years	Target Rate (above BBR) %
Alternative treasury instruments - *note already covered in Treasury Strategy*	**Low**	**20,000**	**1 - 5**	**> 0.1**
Alternative Investments (overall Max):		**50,000**		
Spend to Save	Low	5,000	7	4.0
Loans to Council Companies	Low - Medium	15,000	10	4.0
Loans to Housing Associations	Medium	10,000	20	3.0
Projects which deliver local economic growth	Medium	15,000	5	5.0
Solar Farm (or similar)	Medium	5,000	20	7.0
Commercial investments	High	10,000	10	8.0

4.3 It should be highlighted that the overall maximum exposure for these alternative investments is £50m but the maximums for each individual investment category total £60m to provide a degree of flex within the framework whilst working within the overall £50m.

4.4 Consideration of individual investment opportunities will be subject to detailed business cases with their risks and rewards assessed using the tool outlined in section 2 and returns against the target rates above. Inevitably there will be trade-offs between risk and reward and therefore the rates set above are for guidance only.

4.5 Given the technical nature of such investments and strong linkages to the Council's Treasury Management function, appropriate governance and decision making arrangements are needed to ensure robust due diligence and the necessary agility to act. To oversee the approach and make recommendations for implementation, it is proposed that a Board be established - the draft terms of reference are attached at **Appendix C**.

5. PROPOSALS AND ‘OUTLINE BUSINESS CASES’

Treasury Management

Additional Minimum Revenue Provision (MRP)

5.1 When the Council increases its capital financing requirement (i.e. by the amount of capital expenditure not financed from revenue and/or grants) it must set aside an amount to repay borrowing (internal or external), even if actual external borrowing is not taken. The amount of MRP is determined by the Council’s Minimum Revenue Provision Policy but typically this is the equivalent of the ‘unfinanced’ capital expenditure divided by the life of the asset concerned.

Example

The Council purchases a new office building for £1m with an expected life of 25 years

The cost is funded through internal borrowing (i.e. the Council borrows the money from itself)

An MRP charge of £40k is charged against the Council’s revenue budget (£1m/25 years) to pay back the money borrowed.

5.2 This MRP is a charge against the Council’s revenue budget and hence Council Tax each year and is set aside in a ring-fenced unusable reserve. The physical cash remains within the Council’s accounts and forms part of the investment balances placed with the various banks and institutions on the Council’s lending list, until such time as it is needed to repay borrowing.

5.3 This option would see an additional sum from the Council’s reserves set aside as MRP. The amount available would be subject to a review of the Council’s reserves which currently stand at around £160m (and forecast at £137m by 2019/20). To illustrate the potential, a sum of £10m would save £400k per annum based on a MRP profile over 25 years.

5.4 This options presents low risk in that the cash stays with the Council and it produces a guaranteed annual revenue saving (setting aside lump sums rather than annual revenue contributions). However, whilst it reduces the amount of usable reserves, it is still available for other investment allowing the actual cash held to be invested and deliver an added return until it is needed to repay borrowing. This double benefit makes it the first recommended priority for the £10m set aside for alternative investment.

5.5 Looking forward, consideration could also be given to extending additional MRP beyond the £10m earmarked for investment. The estimated profile of earmarked reserves suggests capacity to achieve this – for example the top-slice of 10% of reserves (excluding public health and schools) could release up to a further £10m for additional MRP contributions, increasing the revenue saving from £400k to £800k p.a. There will be a further review of reserves during 2017/18 and this may create the ability for further MRP contributions should they be seen as favourable.

Debt Repayment

5.6 This follows on from the MRP option above. The Council currently has external borrowing of £317m with varying terms and interest rates. Repayment of borrowing would reduce the Council's Capital Financing Requirement and hence it's MRP charge and would save external interest payments however there may be penalties for loans repaid early.

5.7 Capita, the Council's treasury management advisors regularly review the Council's debt portfolio and current interest rates and future forecasts suggest that it is not beneficial to repay debt at this time as there would be little opportunity for early repayment without the Council incurring substantial early redemption penalties. This will continue to be monitored as part of the Council's on-going treasury management activity.

Payment to North Yorkshire Pension Fund

5.8 The Council has the option to pay one-off sums to reduce the historic deficit on its pension fund. The opportunity arises every 3 years when the results of the latest triennial valuation are factored into the coming 3 years' contribution rates. However whilst there is some immediate reduction in rates arising from such one-off payments a proportion of the benefit is used to reduce the recovery period for the fund which dilutes the annual revenue saving immediately available. Given the other opportunities available to the Council one-off contributions are not recommended at this time – this will be kept under review at each valuation.

Alternative Treasury Management Instruments

5.9 A number of alternative instruments are potentially available to the Council – some already covered by the approved Treasury Management Strategy but not yet used. Typically higher credited rated instruments offer lower rates of return and therefore these types of investment may have limited impact on overall returns. However they do provide alternatives to the investment we currently use and as such may allow us to diversify our portfolio. Options include:

i) Money Market Funds
ii) Enhanced Cash Funds
iii) Certificates of Deposit (CDs)
iv) Property Funds

5.10 A review of the Council's Treasury Management Strategy will be undertaken in the first Quarter of 2017/18 and these opportunities will be explored with the Audit Committee. Current limits for such investments are £20m and assuming a margin of at least 0.25% above current returns an additional £50k p.a. could be generated.

Investment Projects

Loans to LA Companies

5.11 The Council currently owns (in whole or part) a number of companies which have been established to deliver a variety of objectives.

5.12 The Council provides cash flow support to these companies and has £10.1m loans (at 31 March 2017) on its balance sheet at a variety of terms (duration and interest rates).

5.13 Given the nature of the companies and the Council's direct involvement in their operation, relative to other types of investment these are considered lower risk and are currently offered at a rate of bank base rate plus 4%.

5.14 Loans are classed as capital expenditure and financed through internal borrowing in accordance with the Council's Treasury Management Strategy. Current Loans to Limited Companies:

Yorwaste: As at 31/03/17 - £3.7m @ 4% + Base; Fixed Term Maturity. A separate 2nd loan is expected to be finalised for £3.9m in early 2017/18 which is to be re-paid in 10 annual instalments.
NyNet: As at 31/03/17 - £1.95m @ 3% + Base; overdraft arrangement.
NYPS: A drawdown overdraft/loan arrangement up to £500k @ 4% + Base; agreed November 2016 – no drawdown in 2016/17.
NY Aspire: Overdraft arrangement up to £250k @ 4% + Base agreed April 2017.
NY Development: A Loan agreement provided on a drawdown basis up to £2.750m @ 4% + Base, agreed in May 2017.

5.15 It is difficult to predict the needs of these companies but for illustrative purposes an average aggregate additional loan value of £5m, over a term of 10 years at a margin of say 3% above standard investment returns would generate additional income of £150k p.a.

Solar Farm (or similar)

5.16 A feasibility study into the potential for a council owned solar farm has been carried out. Investment of circa £5m could deliver a 5mw land based solar farm. The Council has a number of land holdings which could be suitable for a land based solar scheme (including former land fill sites and county farms sites) although government cuts to the subsidy regime means that costs need to reduce in order to deliver a viable scheme. 'Grid parity' is the point at which it is no more expensive to deliver a solar scheme v other non-renewable methods negating the need for subsidy – based on current price trajectory this is anticipated within the next 2/3 years. A scheme could enable the Council to generate electricity for its own consumption thereby reducing the volume procured and providing corresponding protection from future price rises or it could generate power for sale either back to the grid or direct to commercial or domestic clients (the latter required through a separate electricity supply company).

5.17 Typically it is expected that for an investment of between £4m - £5m a target rate of return of 7% should be set (subject to grid parity) which would give a margin of say 6% and generate an additional return of at least £240k - £300k. The decision to invest in such a scheme would be subject to a separate detailed business case. The business case for a land based solar farm will be kept under review and will be brought forward for consideration should 'grid parity' be reached.

<u>Commercial Property/Local Economic Growth</u>

5.18 Direct investment in commercial property provides the greatest opportunity (of those considered) to improve investment returns, although inevitably this comes with greater risk. Investment could be undertaken purely on a commercial basis or could be aligned to the Council's Economic Development Strategy. Investments on a commercial basis would be required to make an appropriate commercial return.

5.19 Returns could also be linked to the other potential rewards (if any) – for example projects which deliver a level of local economic growth for the Council may be considered at a lower direct rate of return if they increase business rates and/or council tax income.

5.20 Investment in commercial property will require external expert support as this is a high risk market and direct investment in property (as opposed to a property fund which enables some spreading of risk) could carry a greater degree of risk particularly if investment is outside of the county boundary and hence our local market.

5.21 Returns can vary significantly and each opportunity will have to be considered on its merits having due regard to risk and reward. However as a minimum the Council should expect an additional return of at least 7% (net of any agent/management fees etc) for a purely commercial investment and 4% for projects which deliver wider economic growth. Assuming a commercial investment based on say £10m over 10 years, additional income of £700k p.a. could be delivered; and £5m invested in local economic growth projects additional income of £200k could be achieved.

5.22 Considerations for property investment would include specific market conditions, diversity of income (a single tenant v multiple tenants), lease duration(s), asset condition and future liabilities etc. Should there an appetite for this type of investment an agent would be procured to support the Council identify and acquire an appropriate asset(s) and specialist advice would be commissioned to provide the necessary due diligence.

House Building

5.23 The Council has a number of land holdings that may be suitable for housing development. Traditionally the approach for the Council would have been to review such land, identify it as surplus to operational requirements, earmark it for disposal and then sell it on the open market.

5.24 Establishment of the new housing development company provides an opportunity to directly deliver market housing on Council owned land and a cashflow loan of up to £2.75m at 4% + Base has now been agreed over the company's first 2 years of trading. However, given the commercial nature of such ventures it is anticipated that development loans to the company would be at an appropriate market rate – this would be required to satisfy state aid rules. The lack of covenant and track record make it difficult to offer a reasonable alternative market rate but for illustrative purposes it is suggested that a margin of at least 5% would be a prudent assumption for this report. Assuming loans of up to an average of £5.25m (ranging from £500k to £10m) over a 20 year period a return of £260k could be achieved.

Loans to Housing Associations

5.25 In addition to shorter term loans to public sector counterparties through the Council's existing Treasury Management Strategy, there may also be opportunity to provide longer term loans to housing associations for delivery of affordable housing. Housing Associations do not have access to the Public Works Loans Board and a number of associations which operate within the County may therefore be interested in borrowing from the Council to fund housing development schemes. Consideration would need to be given to an appropriate rate, term, loan type (interest only or annuity) and security, which would be part of the due diligence for such loans and would be included within the legal agreement that would be required. Assuming a term of up to 20 years and loans of £5m at a margin of 3%, interest of £150k could be achieved.

Other Projects

5.26 The Council can also consider a variety of spend/invest to save projects within service areas where investment would lead to an on-going revenue saving allowing the up-front investment to be repaid with 'interest'. Examples could include investment in renewable or low energy products as part of our wider review of assets (business case previously considered).

5.27 Given the Council's savings challenge an Internal Rate of Return of 4% (equivalent to the savings target already set) would seem appropriate. However the nature and scale of such projects are so varied and alternative governance arrangements are already in place for such projects that as a rule these are considered out of scope of this alternative investment framework but opportunity remains should an appropriate project come forward.

6. ANTICIPATED RETURNS

6.1 **Appendix A** sets out a summary of the potential returns that could be achieved by adopting the range of investments outlined in this report. The £10m earmarked for alternative investment is proposed to be used to fund additional MRP to deliver an annual saving of £400k.

6.2 However, should approval be given to extend the investment quantum to £50m, annual revenue savings/returns of circa £1.5m could be achieved (subject to projects being identified and approval of business cases).

6.3 In addition there may be the potential to release further earmarked reserves to fund more MRP contributions – for example a further indicative £10m released would generate an additional £400k p.a. savings.

6.4 Internal administration of the investment ‘pool’ would be required and the current Finance savings plan includes an assumption of £20k from this work. Given the proposals to extend the scale of this work an indicative 2% top-slice is proposed which based on returns of £1.91m, would take this to £38k.

7. CONCLUSIONS AND NEXT STEPS

7.1 This report considers the options available for applying the £10m earmarked for alternative investment and recommends maximising the use of a lump sum Minimum Revenue Provision (MRP) contribution to achieve a guaranteed annual saving - £10m set aside as MRP will deliver an annual saving of £400k.

7.2 The report also highlights the potential for further MRP contributions subject to corporate appetite to top-slice earmarked reserves. A review of reserves will be undertaken during 2017/18 to identify the potential for this.

7.3 There are also a number of options within the existing Treasury Management policies which will enable investments of up to £20m and potentially raise an additional £50k p.a. – these will be explored separately as part of our core treasury activity but are included here for completeness.

7.4 In addition, a review of the Council’s cash profile shows that over the next 20 years there will be a core balance of cash that could be invested for periods longer than currently applied through the traditional Treasury Management activities.

7.5 It is proposed that up to £50m of core cash balances be invested in alternative instruments with differing maturity profiles and targets for return. Actual investments would be subject to individual detailed business cases, assessed against the framework set out in this report and recommendations made to the Executive.

7.6 Given the technical nature of the proposed investments and strong linkages to the Council's Treasury Management function, appropriate governance and decision making arrangements are needed to ensure robust processes and the required agility to act. Where necessary specialist advice would be commissioned to provide the due diligence to support this work.

7.7 Subject to views of the Executive, work with key stakeholders to generate ideas and establish the first wave of individual business cases, will commence.

8. RECOMMENDATIONS

8.1 It is recommended that:

- i) The approach set out in this report be approved;
- ii) The investment limits (maximum amounts and durations) set out at paragraph 4.2 be approved;
- ii) That the governance arrangements at Appendix C be approved;
- iii) That the £10m earmarked for debt reduction be a set aside as voluntary Minimum Revenue Provision (MRP) in 2017/18.

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APPENDIX A

Indicative Investment/Returns

Alternative Investment Options	Indicative Investment £000's	Term Years	Indicative Rate (Margin)	Annual Return/Saving £000's	Priority
Additional MRP (non-cash movement)[1]	**10,000**	**N/A**	**4%**	**400**	**1**
Treasury instruments	**20,000**	**1 – 5**	**0.25%**	**50**	**2**
Alternative Investments					
Loans to LA owned companies (excluding house building)	5,000	10	3%	150	**2**
Local economic growth	5,000	5	4%	200	**3**
Commercial property – investment only	10,000	10	7%	700	**2**
House building (loans to housing development company)	500 - 10,000	3 - 10	5%	260	**2**
Loans to housing associations	5,000	20	3%	150	3
Total Alternative Investments (subject to risk appetite)	**29,000**		**5%**	**1,460**	
Total annual saving/income [2]				**1910**	

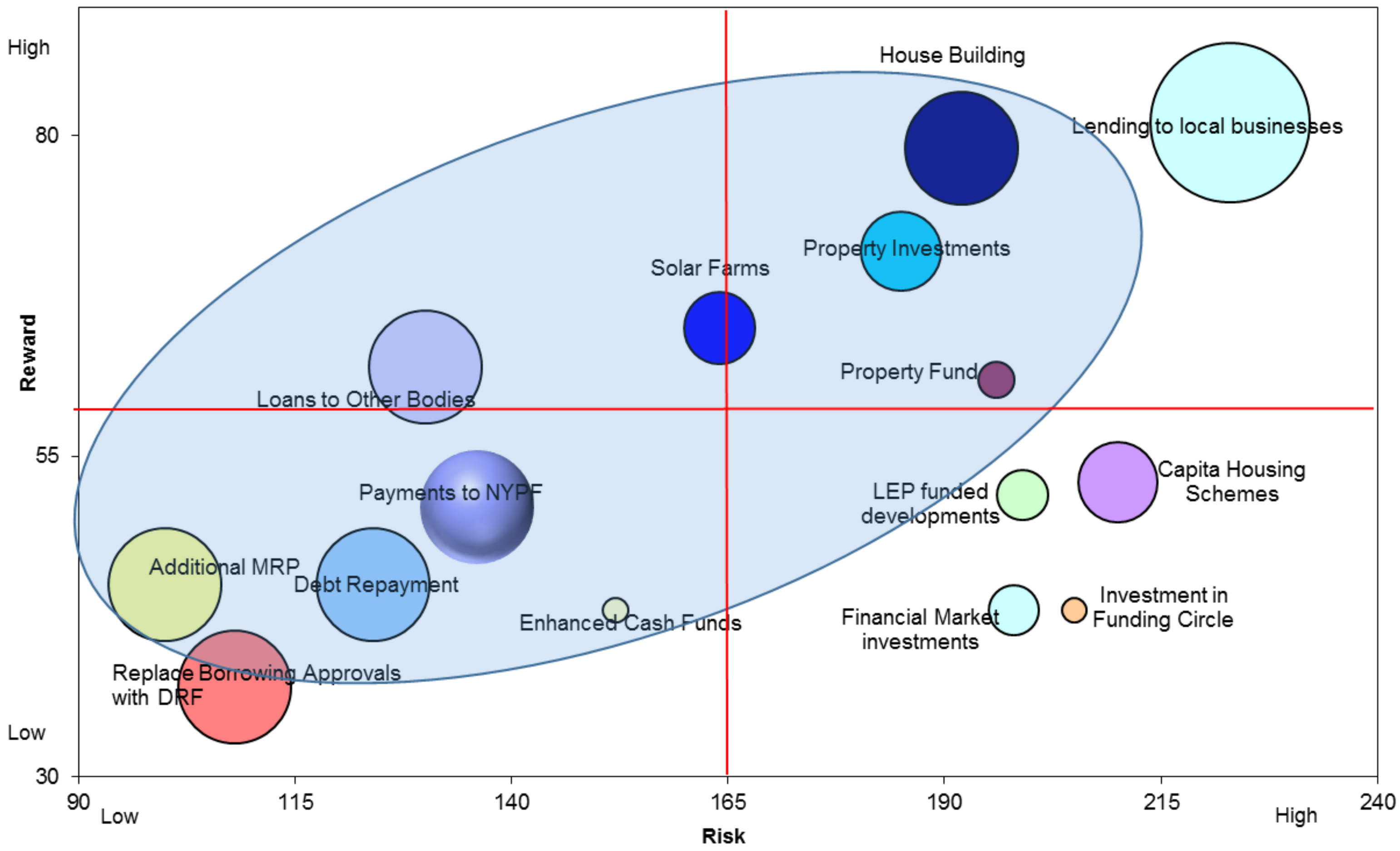
NOTES:

1 Potential to increase this subject to appetite and ability to top-slice earmarked reserves – for example a further £10m would add another £400k to the return/annual saving.

2 Target saving/income per project brief 5%/£500k

Appendix B

Investment Opportunities – risk/reward



Appendix C

Alternative Investments Board – Proposed Governance

Purpose

The Board will not be a constituted body and will therefore not have formal decision making powers. However, it will be the chief means of identifying, reviewing and recommending schemes for investment decisions. Such formal decisions will be taken within the existing delegations namely through delegated authority to the Corporate Director, Strategic Resources and further decisions as made by the Executive.

To consider and recommend detailed business cases for alternative investments within the framework approved by Executive.

To approve individual investments to a limit of £1m per investment and up to a total of £5m in any one financial year.

To consider appropriate due diligence proportionate to the investment/risk/reward proposed.

Notwithstanding the Corporate Director, Strategic Resources authority to terminate investments should concerns be raised - to consider and recommend cases for early termination of alternative investments.

To monitor returns against approved performance targets.

To report performance of alternative investments to the Executive on a quarterly basis

To make recommendations to Executive on any proposed changes to the framework.

Membership

Lead Member for Finance (Chair)

Lead Member for Growth

Corporate Director Strategic Resources

Corporate Director Business and Environmental Services

Assistant Director Strategic Resources – LBP to CFO

Assistant Director BES - Growth, Planning and Trading Standards

Frequency of meetings

Board meetings likely to be held quarterly however the nature of investment opportunities will require agility and meetings will be arranged as required outside of the quarterly schedule.