SECTION 10

10. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2005/2006

Introduction

10.1 This section of the report presents:

(a) The 2005/06 Treasury Management Strategy that sets out the proposed borrowing and lending policy and the factors that will influence this over the coming year.

(b) The 2005/06 Annual Investment Strategy sets out the security of the investments made by the authority.

10.2 Previously Part IV of the Local Government and Housing Act 1989 provided for a system of local authority capital finance that regulated Local Authority borrowings. This has been replaced from 1st April 2004 by the Prudential Code, details of which are set out in Section 11 of the Budget report, and the requirement for an Annual Investment Strategy.

10.3 Members are asked to agree the Treasury Management and the Annual Investment Strategies for 2005/2006 as part of the main recommendations to the report.

TREASURY MANAGEMENT STRATEGY 2005/2006

10.4 The 2002 Code of Practice for Treasury Management issued by the Chartered Institute of Public Finance (CIPFA) includes provision for an annual report to members on the Treasury Management Strategy. The code requires that members consider and agree the strategy before the beginning of the financial year. The Treasury Management Strategy is sensitive to interest rate movements, which may affect receipts from interest on balances, or payments of interest on new long term loans to the authority.

Economic Background

10.5 The international economic background has been of rising stock markets, sharp increases in the price of oil and a falling dollar. Interest rates have risen but remain low – The Federal Reserve rate in USA has risen to 2.25%, UK base rate to 4.75%, and the European Central Bank rate remains at 2%. In the largest economy, the USA, growth remains at 4% after a 'soft patch' in the middle of 2004. Activity in Europe is sluggish, undermined by sharp falls in the value of the dollar against the euro. Other economies are enjoying healthy growth. Such synchronised growth may lead to further rises in interest rates, particularly in USA.

10.6 The UK scenario has been benign. Increased government and consumer spending have supported activity so that unemployment has fallen. Low

interest rates have fuelled sharp rises in house prices. GDP has grown by around 3.25% in 2004 (2.1% for 2003), well above trend. However, inflation as measured by RPIX has fallen to 2.2%, and to 1.5% as measured by the new Bank of England inflation measure, the Core Price Index (CPI – this excludes housing costs and council tax increases). Currently longer-term interest rates have fallen (to 4.6% from 5%) as the market expects short term rates to fall next year.

10.7 Looking ahead to March 2006, it is expected that world economic growth will slow. USA short-term interest rates are likely to rise to 3% - 4% in 2005, and longer rates may rise to control inflationary pressures. In UK, the market anticipates that economic growth will slow to 2.5% - 3% in 2005 and that base rate will remain around 4.75%, possibly falling in 2005 – a leading forecaster, Capital Economics, anticipates base rate at 4% by the end of 2005, whereas the OECD has called for rates to rise to 5.75%. However, the use of CPI at 2% as a target may restrain rising rates. It is also anticipated that ten-year rates will remain around 5%, but there may be some upward pressure if USA rates rise.

Lending Policy

10.8 Table 10.1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £86m by 1st April 2006 as the authority maintains long-term borrowing at the capital financing requirement (see paragraph 10.12).

Table 10.1 Cash Flow Summary 2005/2006

	£m	£m
Cash Balances as at 1 April 2005		**86**
Capital Programme	(66)	
Debt Repayment	(30)	
		(96)
Capital Receipts/Grants	7	
Increase in balances	-	
Long-term borrowing	82	
Minimum Revenue Provision	7	
		96
Cash Balances as at 31 March 2006		**86**
Total long-term borrowing as at 31.3.05		**520**

10.9 Two companies, Aberdeen Asset Management and Alliance Capital, manage external portfolios valued at £18.2m each under arrangements that were reviewed in 2003 and 2004. The managers are allowed to use certificates of deposit, supranational bonds, government gilts and cash to enable them to improve performance. Aberdeen suffered adverse publicity through the

collapse of another branch of their business (split capital trusts), so that an in depth review of the house investment processes was undertaken in 2003. The findings were favourable – both processes and people gave reasons for confidence - and Aberdeen has outperformed the benchmark in 2003/4 (Aberdeen 3.7%, 7 day LIBID 3.63%) and 2004/5 (Aberdeen 2.25%, 7 day LIBID 2.18%) to date. More recently, concerns arose over the performance and investment approach followed by Morley Fund Management, leading to a review of the external management arrangements in 2004. It was decided to replace Morley with Alliance Capital and to equalise the two portfolios. The remaining balances are managed in house on the basis of a treasury lending list that uses credit ratings supplied by Fitch Ratings, an international rating agency, and others. The lending policy seeks to protect capital whilst generating interest payments to support the revenue budget.

10.10 As set out above, it is expected that rates will remain around 4.75%. In-house lending policy will seek to improve returns by lending for longer periods when it is felt that the market is too pessimistic about rising rates or to protect against falling rates if necessary. The policy will be subject to constant review as fresh data becomes available.

Borrowing Policy

10.11 Long-term interest rates have fallen in 2004 as markets have anticipated the top of the tightening cycle and as money has flowed out of dollar investment. It is anticipated that long-term rates will remain fairly stable (around 5%) during 2005/2006.

10.12 Borrowing policy in 2005/2006 will be determined by a number of factors:

(a) The Capital Financing Requirement (CFR) is the difference between the authority's total liabilities in respect of capital expenditure financed by borrowing and the provision that has been made to meet those liabilities in the revenue accounts. Research by the council's treasury adviser, Sector, has indicated that CFR is - at present - the most economical level for the authority's long-term debt. In 2005/2006 new debt will be borrowed in line with the CFR. If short-term interest rates remain low, some debt may be taken at variable rates that follow short-term rates. This approach has the advantage of reducing borrowing costs if rates remain low, matching reduced receipts from lending. Other debt may be taken for longer periods as opportunities allow, to ensure that maturities are spread.

(b) The need to borrow. The cashflow summary indicates a need to borrow in 2005/06. It is also felt to be prudent to retain a level of investments that facilitate effective treasury management and maintain long-term borrowing at the CFR.

(c) Movements in interest rates during the year. The current 10 year gilt rate of 4.6% is, theoretically, composed of elements to cover expected inflation (2% - 2.5% for RPIX, CPI 1.5% - 2%), a real yield (usually about 2.5% - 3%) and a risk premium (around 0.5%). On the basis of

RPIX, this implies either that long-term rates are low and may rise marginally, or that inflation will remain low and that the risk premium is lower.

(d) The Prudential limits to borrowing as agreed by the Council (see section 11).

10.13 It is therefore proposed to replace the £30m maturing debt during 2005/2006, and maintain a portion of the debt portfolio at variable rates. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

Debt Restructuring and Use of the Provision for Credit Liabilities

10.14 Most long-term loans were borrowed from the PWLB during periods when interest rates were very high. The regulations under which such loans were given previously prevented their repayment without incurring a substantial premium to reflect any difference between current low rates and previous higher rates. This could make the repayment of long-term debt with high interest rates expensive, especially if charged to the revenue budget for any one year. Restructuring activity increased sharply in 2003/2004 – resulting in a saving of £3m per annum - and a further £20m has been restructured in 2004/5.

10.15 Market loans known as LOBOs (Lenders Option, Borrowers Option) are long-term loans (up to 40 years) that allow the lender the option to increase the rate after a period of years. The borrower also has the option to refuse to pay a higher rate and repay the loan. An additional feature is that the lender may finance any premium due to the PWLB on premature repayment of a loan through the interest rate paid. The lender will thereby be concerned not to increase the interest rate payable and allow the borrower to repay the loan, avoiding the previous PWLB premium. To date Brent has taken 14 LOBOs, valued at £65.5m. The council may take more LOBOs if opportunities arise, but the current level of exposure will only make new loans attractive at low rates.

10.16 There are also other occasions when refinancing may be advantageous:

(a) When rates rise, but are expected to fall again later. In such cases it may be advantageous to switch to variable rate debt before fixing back into lower rates.

(b) If debt has a short period to maturity but market interest rates are unduly pessimistic.

10.17 It is proposed to continue monitoring opportunities for debt restructuring and to take action as circumstances allow.

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Background

10.18 As part of the prudential framework established for capital finance in local authorities, the 1990 Regulations have been replaced by Guidance issued under Section 15 (1) (a) of the Local Government Act 2003. The Guidance is less prescriptive than the 1990 Regulations, but seeks to ensure that local authorities demonstrate sound procedures to manage treasury balances. The main points are as follows:

(a) Authorities should adopt the CIPFA Treasury Management Code.

(b) Prudence is fundamental. Authorities should seek the highest rate of return consistent with proper levels of security and liquidity.

(c) Authorities should prepare an Annual Investment Strategy (AIS), to be agreed by Full Council before the commencement of each year.

(d) The AIS will set out the security of investments used by the authority, analysed between Specified and Non-Specified investments and clarifying the use of credit ratings. It will also set out the maximum periods for which funds may prudently be committed (liquidity).

(e) To discourage the use of investments that may be considered speculative, such as equities, the acquisition of share or loan capital in any body corporate (such as a company) is defined as capital expenditure. On this basis, Brent will not invest treasury balances in shares, corporate bonds or floating rate notes issued by companies.

Annual Investment Strategy

10.19 The proposed AIS for 2005/2006 is attached as Appendix L, using a template produced by Brent's treasury adviser, Sector. Investments are categorised as either Specified or Non-specified Investments. The AIS is the same as that followed in 2004/2005.

(a) Specified Investments (as set out in the Guidance) are those that offer high security and liquidity. Such investments will be in sterling, with a maturity of no more than one year, and will be made to bodies with high credit ratings – UK or local government, banks, building societies, money market funds, and supra-national institutions.

(b) Non-specified Investments (as set out in the Guidance) are those that may either entail more risk or are more complex, such as gilts, certificates of deposit or commercial paper. In all cases where time deposits (loans to banks, building societies etc) are NOT involved, external fund managers will take investment decisions within their Investment Management Agreements.