SECTION 11

11. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2006/07

Introduction

11.1 This section of the report presents:

a) The 2006/07 Treasury Management Strategy which sets out the proposed borrowing and lending policy and the factors that will influence this over the coming year.

b) The 2006/07 Annual Investment Strategy which sets out the security of the investments made by the authority.

11.2 Under the Local Government Act 2003, local authority borrowing is regulated by the Prudential Code, details of which are set out in Section 12 of this report, and the requirement for an Annual Investment Strategy.

11.3 Members are asked to agree the Treasury Management and the Annual Investment Strategies for 2006/07 as part of the main recommendations to the report.

Treasury Management Strategy 2006/07

11.4 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

11.5 The international economic background has been benign despite rising oil and commodity prices. Economic growth has continued to be strong – the largest economy, the USA, has grown by 4% in 2005, Europe by 2%, China and India by 7% - 10%. Stock markets have risen sharply. The interest rate picture is more mixed but rates remain low. The Federal Reserve rate in USA has risen to 4.25% (from 2.25%), and the European Central Bank rate to 2.25% (from 2%). However, the UK base rate has fallen marginally to 4.5% (from 4.75%) and Japanese rates remain nil. Longer term rates remain very low – UK 10 – 50 year rates are around 4%, the lowest real rates since records began, and European 10 year rates are 3.3% – as high saving in Asia, low cost production, reduced investment in developed countries and pension fund investment in bonds combine to push down rates.

11.6 The UK scenario has been of slowing growth and worries about rising inflation. The UK economy has grown by 1.6%, sharply down from 3.25% and well below government predictions. Previous increases in base rates, higher taxation and a slowing housing market combined to reduce consumer activity. However, inflation as measured by the RPI has fallen from 3.5% a year ago to 2.2% now and RPIX (which excludes mortgage interest) has fallen from 2.5% to 2.0% over the same period. Currently longer-term interest rates have fallen (to 4% from 4.6%), and the market expects short term rates to fall next year.

11.7 Looking ahead to March 2007, it is expected that world economic growth will slow marginally. USA short-term interest rates are likely to rise to around 4.75% in 2006 to reduce inflationary pressures. It is also anticipated that the European Central Bank may raise rates further, to around 3%, but that Japanese rates will remain stable. In the UK, the market anticipates that base rate will fall marginally – to 4.25% - to boost economic growth as inflationary pressures abate. However, inflationary pressures remain and may maintain rates around 4.5%. The government may also be unwilling to re-inflate consumer expenditure, preferring business-led growth. Long-term rates are more difficult to forecast – the savings glut, deflationary pressures and pension fund activity may combine to keep rates at very low levels, though it is expected that investment may rise. This is the forecast of various investment houses. On the other hand, long rates are theoretically based on inflation (around 2%), a real rate of return (around 2.5% - 3%) and a risk premium (around 0.5%) – giving rates of around 5%. Experience suggests that current low rates are an aberration, but this could continue for some while.

Lending Policy

11.8 Table 1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £100m by 1st April 2006 as the authority maintains long-term borrowing at the capital financing requirement but takes advantage of low long-term rates to fund the 2006/07 capital programme early (see paragraph 11.12).

Table 1 - Cash Flow Summary 2006/2007

	£m	£m
Cash Balances as at 1 April 2006		**100**
Capital Programme	(50)	
Debt Repayment	-	
		(50)
Capital Receipts/Grants	23	
Increase in balances	-	
Long-term borrowing	-	
Minimum Revenue Provision	8	
		31
Cash Balances as at 31 March 2007		**81**
Total long-term borrowing as at 31.03.06		**577**

11.9 Two companies, Aberdeen Asset Management and Alliance Capital, manage external portfolios valued at £19m each. The managers are allowed to use certificates of deposit, supranational bonds, government gilts and cash to enable them to improve performance, with a target of outperforming their benchmarks by 0.5% per annum. 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 2003/04, 2004/05 and 2005/06 to date (Aberdeen 3.72% benchmark 3.5%). Alliance Capital was appointed at the end of 2004, and has marginally underperformed a higher, gilt related benchmark in 2005/06 to date (Alliance 3.67%, benchmark 3.76%). The remaining balances are managed in house on the basis of a treasury lending list that uses standard credit ratings. The lending policy seeks to protect capital whilst generating interest payments to support the revenue budget.

11.10 As set out above, it is expected that rates may fall to around 4.25% / 4.5%. 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

11.11 Long-term interest rates have fallen in 2005 (from 4.6% to 4%) for reasons set out in paragraph 11.5. It is anticipated that long-term rates will rise marginally, but remain low (around 4.5%) during 2006/07.

11.12 Borrowing policy in 2006/07 will be determined by a number of factors:

(a) The Capital Financing Requirement (CFR). This 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. On the advice of our treasury adviser (Sector), Brent borrowed £20m of its 2006/07 requirement in December 2005 and £10m in January 2006, to take advantage of low long-term rates. In 2006/07 a further £7m new debt will be borrowed in line with the CFR. If short-term interest rates reduce sharply, 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. However, it is expected that the £7m will be taken for longer periods if low rates continue, allowing maturities to be spread and locking into low rates.

(b) The need to borrow. The cashflow summary indicates a need to borrow in 2006/07. 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% is, theoretically, composed of elements to cover expected inflation (2% - 2.5% for RPIX), a real yield (usually about 2.5% - 3%) and a risk premium (around 0.5%). This implies either that long-term rates are low and may rise marginally, or that inflation will fall and that the risk premium is lower.

(d) The Prudential limits to borrowing as agreed by the Council (see Prudential Code section of the Budget report, Section 12).

11.13 It is therefore proposed to borrow a further £7m in 2006/07. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

Debt Restructuring and Use of the Provision for Credit Liabilities

11.14 Many long-term loans were borrowed from the PWLB during periods when interest rates were very high. The regulations under which such loans were given prevent 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 2003/04 – resulting in a saving of £3m per annum - and a further £20m was restructured in 2004/05.

11.15 Market loans known as LOBOs (Lenders Option, Borrowers Option) are long-term loans (up to 60 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. Local authority debt is regarded as of high quality to lending institutions, who are keen to grow such business on their loan books. To date Brent has taken 15 LOBOs, valued at £75.5m. The council may take more LOBOs if opportunities arise, but the current level of exposure will only make new loans attractive at low rates.

11.16 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.

11.17 It is proposed to continue monitoring opportunities for debt restructuring and to take action as circumstances allow. In a low interest rate environment, there are few opportunities to restructure. Activity may also be hampered by possible accounting changes under Financial Reporting Standard (FRS) 25 and FRS26, where there are proposals to charge any debt premia arising from early repayment in the year in which it arises. A further report will be issued when the situation is clear.

ANNUAL INVESTMENT STRATEGY 2006/07

Background

11.18 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

11.19 The proposed AIS for 2006/07 is attached as Appendices N (i), (ii) and (iii) 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 2005/06.

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 with a fixed maturity date to banks, building societies etc) are NOT involved, external fund managers will take investment decisions within their Investment Management Agreements.