SECTION 11

11. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2010/11

Introduction

11.1 This section of the report presents:

a. The 2010/11 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b. The 2010/11 Annual Investment Strategy setting 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 the Budget Report, and the requirement for an Annual Investment Strategy.

11.3 Members are asked to agree

a) The Treasury Management Strategy for 2010/11 as part of the main recommendations to the report, and to note the changes outlined in para. 11.18.
b) The amendments to the Annual Investment Strategy to cover new requirements on duration (para.4.3), other sources of market information (para. 5.2), use of Advisers (paras 10.1 and 10.2), borrowing money in advance (paras 11.2 and 11.3) and staff training (paras 12.1, 12.2 and 12.3).

Regulatory Requirements

11.4 The 2009 Code of Practice for Treasury Management issued by the Chartered Institute of Public Finance and Accountancy (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 each 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.

11.5 Guidance issued under Section 15 (1) (a) of the Local Government Act 2003 also requires that authorities should prepare an Annual Investment Strategy (AIS) to be agreed by Full Council before the commencement of each year. The AIS is required to 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 also has to set out the maximum periods for which funds may prudently be committed (liquidity). 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 does not invest treasury balances in shares, corporate bonds or floating rate notes issued by companies except through pooled schemes.

11.6 The Department for Communities and Local Government (DCLG) has recently issued revised draft Guidance following the collapse of Lehman Brothers and various Icelandic banks, and the House of Commons Select Committee report on local authority investments in Icelandic banks. Although the Guidance remains 'draft', it is proposed to include the main issues raised within the AIS. These are:-

a) Security and liquidity are the key issues in lending. There should clear policies on the duration of loans, and the share of the portfolio that can be lent for longer periods.
b) The Treasury Strategy should be approved by Full Council. Authorities should consider sending revised strategies to members during the year.
c) The Treasury Strategy should be published.
d) Local Authorities should not rely solely on credit ratings but consider other information.
e) The Treasury Strategy should comment on the use of advisers.
f) The Treasury Strategy should comment on the investment of money borrowed in advance of need. The Guidance confirms that it is legitimate for authorities to borrow in advance, but is concerned that the consequent loans into the market should be legitimate and not be speculative.
g) The Treasury Strategy should comment on how staff training is reviewed and training needs met.
h) The Treasury Strategy should include proposals for regular scrutiny by members.

11.7 The proposed AIS for 2010/11 is attached as Appendix N. Given the issues that have arisen recently as a result of turmoil in financial markets, details of the actions the council plans to take in both the short and longer term with regard to investments and use of credit ratings are set out in this section of the main report.

Economic Background

11.8 The international economic background in 2008 was extremely volatile, with rising oil and commodity prices, and a credit crisis that led to the collapse / takeover / rescue of various banks as inter bank lending and the wider provision of credit reduced. In 2009, recession, low interest rates and market recovery have been the main features, as follows:-

a) Economic growth has been negative. The UK economy shrunk by around 4.5%, the European economy by 4%, and the USA by 2.5%. However, most developed economies have emerged from recession in Q3 2009, and UK GDP grew by 0.1% in Q4 2009.

b) Stock markets fell in anticipation of a recession, but have risen by around 50% since the trough in March.

c) House and property prices fell during the first half of the year, but have risen since.

d) Inflation initially fell sharply on the back of the cut in VAT and falling fuel costs, but has risen by 2.9% for 2009 as a whole.

e) Short term interest rates have remained very low (UK 0.5%, USA 0% - 0.25%, ECB 1%) as Central Banks have sought to support economic activity and recapitalise the banks. The interest rates used for lending and borrowing between banks, LIBOR and LIBID, have reduced towards base rate as expected. Longer term rates have been held down by quantitative easing in UK and USA, but are rising on hopes of economic recovery and the weight of government gilt issuance required to support expenditure.

11.9 Looking ahead to the next financial year, it is expected that world economic growth will accelerate to around 3% / 3.5% in 2010, led by growth in emerging economies such as China. Although the USA economy should grow by around 3% in 2010, it is anticipated that UK and Europe will only grow by around 1% / 1.5%. It is also forecast that UK GDP will only increase by 1.5% in 2011. Interest rates should continue to be very low – UK Bank Rate may remain at 0.5% throughout 2010, possibly rising to 1% towards the end of the financial year. Despite quantitative easing, it is expected that the authorities will have few worries about inflation – although RPI and CPI will rise early in 2010 as a result of VAT rising back to 17.5% and increased oil costs, inflation is expected to fall in the second half of 2010. Long-term rates are expected to rise as governments borrow money to fund recovery programmes and the costs of nationalising / recapitalising banking sectors. However, there remains a risk that deflation will pose a greater threat than inflation, leading to lower rates.

Financial Market Background

11.10 The sub-prime crisis and credit crunch of 2007 – 2009 led to the collapse of a number of banks, either into nationalisation, forced mergers or disappearance. However, the collapse of Lehman Brothers – a key broker and investment bank – in September 2008 caused a financial tsunami to overrun the banking system.

11.11 Although the financial institutions on the Brent Lending List were sound and most were given support by their national banks, three Icelandic banks were put into administration when their credit ratings were reduced and they were unable to meet short term obligations. Brent had two deposits outstanding, as follows:-

Heritable Bank	£10m	Lent 15.08.08	Repayable 14.11.08
Glitnir Bank	£5m	Lent 15.09.08	Repayable 12.12.08

To date, the council has had £2.9m returned by the administrators of Heritable Bank, who suggest that depositors will recover about 80% of their original sum. It is anticipated that the £5m deposited with Glitnir will be returned as legal advice is that the deposit will be treated as a preferential creditor

However, progress is likely to be slow in the light of legal challenges, especially from the Winding up Board for the Bank. If the deposits are not returned in 2010/11, the lost interest will be around £60,000 (assuming an interest rate of 0.5%).

11.12 In the light of the turmoil on the financial markets, the Lending List agreed by the Director of Finance & Corporate Resources was reconstructed to reduce risk – initially foreign and lower rated British banks were removed and lending limited to a duration of one month, then in April 2009 building societies were also removed from the List following concerns about the Dunfermline Building Society. In March 2009 the council repaid early loans from the PWLB valued at £64.75m, thus generating substantial savings (£1.5m per annum) and reducing balances available to deposit with other banks (currently at very low interest rates). The repayment reduced council long term borrowing to £597.5m, £29.5m below the level of the Capital Financing Requirement at the end of the 2008/09 financial year

Lending Policy

11.13 Treasury management is defined as the management of the organisation's cash flows and 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.

11.14 Table 11.1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £56m by 31st March 2011 if the council resumes long-term borrowing at the Capital Financing Requirement.

Table 11.1 - Cash Flow Summary 2010/11

	£m	£m
Cash Balances as at 1 April 2010		**50**
Capital programme	(116)	
Debt repayment	(-)	
		(116)
		(66)
Repayment by Heritable	2	
Capital receipts/grants	68	
Payment of debt premia	4	
Long-term borrowing	38	
Minimum Revenue Provision	10	
		122
Cash Balances as at 31 March 2011		**56**
Total long-term borrowing as at 31.03.10		**635**

11.15 It was agreed that the revised list should remain in effect until the problems in the inter-bank market – as represented in the wide spreads between LIBOR / LIBID and bank rate – were reduced, and to continue to lend for periods of less than one month. Although these measures marginally reduced interest receipts, income has been protected by a number of longer term deposits that run into 2009/10 and beyond. Furthermore, the March 2009 repayment has meant that the Council has had minimal balances to lend.

11.16 In January 2010 it was felt that the market had recovered significantly and that debt defaults would reduce in 2010. Following consultation with the adviser, Butlers, and a report to the Audit Committee, the Director of Finance and Corporate Resources increased loan duration to one year, reinstated a suitably rated building society to the lending list and increased the size of loans to local authority and government institutions, as shown in Table 11.2 below.

Table 11.2 – Current Brent Lending List – February 2010

A. UK BANKS – UP TO £10M for INDIVIDUAL banks or Banking GROUPS, or building societies as indicated below

Rated AA- or above long, F1+ short term, B/C or above individual, 1 support (unless part owned by the government or supported by an implicit guarantee). Up to one year

Bank of Scotland
Lloyds Bank – linked with Bank of Scotland as part of Lloyds

Barclays Bank PLC
HSBC Bank

National Westminster
Royal Bank of Scotland – linked with Nat West as part of the RBOS group

Nationwide building society

B. MONEY MARKET FUNDS –UP TO £12M

Rated AAA

Royal Bank of Scotland
Morgan Stanley Cash Fund
Northern Trust

C. DEBT MANAGEMENT OFFICE – NO LIMIT – up to one year
D. OTHER LOCAL OR GOVERNMENT AUTHORITIES – up to one year
E. SUPRANATIONAL INSTITUTIONS – UP to £10M

AAA long term and F1+ short term ratings that are supported by major international organisations such as the USA FED or the European Central Bank. These have only ever been used by external managers

11.17 The 2009 CIPFA Code of Practice in Treasury Management recommends that authorities should have regard to the credit ratings issued by all three main rating agencies, and make their decisions on the basis of the lowest rating.

Two of the British banks, Royal Bank of Scotland and Lloyds, are rated lower (A+) by one of the rating agencies, but they have not been removed from the lending list on the grounds that they are part owned by the government as well as supported by an implicit government guarantee that allows them to issue certificates of deposit.

11.18 Over the longer term there are operational difficulties in running a reduced Lending List and a cost in foregone interest receipts. It is proposed that, if market conditions remain calm, the Council returns to using a longer Lending List in April. The Lending List will incorporate the features outlined in the 2009 Treasury Strategy report, as follows:-

a) Sovereign ratings, linked to the country of ownership, to the level of AA (a strong capacity to meet its financial obligations) and above in developed economies. There will be a limit of 20% on individual country exposure, with the exception of UK.

b) An institution will only qualify for the list if its lowest ratings (from one of the three agencies) meet the criteria.

c) Institutions that are part of a financial group (for example, Lloyds TSB includes Lloyds TSB, HBOS, Halifax and Cheltenham and Gloucester) will be subject to a group limit of £10m.

d) The use of independent credit information produced by asset managers, as a check on the Brent List.

e) Following the collapse of Dunfermline Building Society and evidence that regulators were not closely overseeing building societies, these were removed from the Brent List. As the regulatory regime has been strengthened, and there is clear evidence that the sector continues to weed out weaker societies, concerns have faded. Options for building societies to return to the Lending List will be reviewed with our treasury adviser, Butlers. However, to ensure that risk is spread, no more than 50% of in-house deposits will be lent to the building society sector, and amounts lent will be limited to £5m.

f) A minimum rating of A+ long-term (A is high credit quality), F1 short term (up to 13 months – highest credit quality), B Individual (B is a strong bank, with no major concerns about its functions), and 1 Support (extremely high probability of external support) will be applied. These are high quality ratings, but would allow the return of some overseas banks that may be active borrowers whereas most large UK deposit banks will only take very large deposits.

g) No deposits will be made to companies or countries that are on a negative rating watch, unless there is an implicit government guarantee, enabling the bank / building society to issue certificates of deposit.

h) There will continue to be differential lending periods according to credit rating, but a common maximum deposit of £10m, apart from government related agencies and AAA rated money market funds. The maximum lending period will be reduced to three years (with senior management approval).

11.19 Details of the basis on which credit ratings are used are set out in Table 11.3 below.

Table 11.3 – Use of Credit Ratings

a) The credit rating agencies (Fitch, Moody's and Standard & Poor) meet with financial institutions, review their financial prospects and issue ratings. b) The main source of ratings used by Brent is Fitch, which uses four sets of criteria which can be used as an overall grid. This approach should reduce risk, and is followed by a number of other authorities – though some authorities only use two ratings (long term credit and short term credit). The other two rating agencies do not issue support ratings. c) The Fitch ratings are as follows: i. Long term credit ratings are a benchmark of probability of default. The scales are split between investment and speculative grade – Brent only uses investment grade, which is spread from AAA – highest credit quality – to BBB – good credit quality. ii. Short term credit ratings are a benchmark of the probability of default, but with a 13 month time horizon. These are usually most relevant to our activity. The scale spreads from F1 (P1 for Moody's) – highest credit quality – to D, which is default. iii. Individual ratings are assigned only to banks and attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. The rating looks at soundness of balance sheets and business models. There are often no ratings for subsidiaries. The scale spreads from A, a very strong bank, to F, a bank that has either defaulted or would have defaulted had it not been given support. iv. Support ratings indicate whether or not the bank will receive support should this be necessary. The scale spreads from 1, extremely high probability of external support, to 5, where support cannot be relied upon.

11.20 At present, the investment company, Aberdeen Asset Management, manages an external portfolio valued at £23m, whereas the in-house manager has around £30m. There is previous authorisation for a second external manager, but it is felt to be prudent to wait for more stable markets before making an appointment. The external manager follows the Brent lending list, and is allowed to use certificates of deposit (CDs), supranational bonds, government gilts and cash to enable them to improve performance, with a target of outperforming their benchmark by 0.5% per annum. The manager outperformed substantially in 2008/09, and has outperformed again in 2009/10 to date using longer dated (one year) CDs. It is felt prudent to retain external managers with different benchmarks, encouraging diversification.

11.21 As set out above, rates are at 0.5% and are expected to remain at that level or rise marginally (to 1%) during the year. In-house activity will continue to benefit from previous long-term deposits that will continue into 2010, and will seek to lend for longer periods when appropriate. However, reduced cash balances following the March 2009 restructuring ensures that most cash is used for day to day cash flow purposes. The 2010/11 budget assumes that Brent will receive a further payment from Heritable bank (20% in July 2011), but no payments from Glitnir, and that there will be no interest paid on deposits that are outstanding.

Borrowing Policy

11.22 Long-term interest rates initially fell in 2008/09 as quantitative easing reduced the cost of borrowing. However, rates have recovered to their initial levels (50 year 4.5%) as markets looked through the end of quantitative easing and toward the sharp increase in gilt issuance. It is anticipated that long-term rates may rise further in 2010/11, but there are conflicting pressures. Rates may be reduced as a result of deflationary fears, or increases in taxation / reductions in government expenditure. The budget uses a prudent assumption of an average interest rate of 5%.

11.23 Borrowing policy in 2010/11 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 advisers has previously indicated that CFR has been the most economical level for the authority’s long-term debt. In 2010/11 a further £30m (assuming that borrowing was at CFR at the beginning of the year) new debt would be required in line with the CFR. However, whereas before 2008 the interest rate curve had been ‘inverted’, with long term rates lower than short term rates, the curve has now normalised so that it may be advantageous not to borrow up to CFR but use relatively cheaper, short term debt and reduce lending. However, if long term rates are expected to rise to allow the government to fund its deficit through gilt issuance, it may be advantageous to take long term debt despite the short term cost. Alternatively, 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.

b) The need to borrow. The cash flow summary indicates a need to borrow in 2010/11 if the target is CFR.

c) Movements in interest rates during the year. The current 50 year gilt rate of 4.5% is, theoretically, composed of elements to cover expected inflation (2.5% - 3% for RPIX), a real yield (usually about 2.5% - 3%) and a risk premium (around 0.5%). This implies either that current long-term rates are low and may rise marginally, or that inflation will remain very low and that the risk premium is lower. Market commentators expect inflation to remain low, at least in the short term (after an initial ‘blip’), but are less optimistic over the medium term.

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

11.24 It is proposed to borrow a further £38m in 2010/11 for the main capital programme. Officers will also look at market forecasts to confirm the advantages/disadvantages of borrowing early to fund major developments. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

Prudential Indicators

11.25 Under the revised Treasury Management Code issued in 2009, the treasury prudential indicators are to be included within the treasury management strategy report. The Code requires increased analysis of loan duration, so that all loans above ten years are shown in ten year bands. The prudential indicators are as follows:

a. Adoption of the CIPFA Code of Practice for Treasury Management. This was adopted by the Council in September 2002. Amongst other things, it requires publication of an annual treasury management strategy and investment strategy.

b. Exposure *to changes in interest rates:*
   - *Upper limit on net borrowing at fixed interest rates.* This has been set at 100% on the basis that all net borrowing may be at fixed rates if it is anticipated that short-term rates are set to rise and long-term rates are perceived to be low. Variable interest borrowing would be retained up to the level of any variable interest investments;
   - *Upper limit on net borrowing at variable rates.* This has been set at 40%. Variable rate borrowing is held as a hedge against variable rate investments. It also may be held where variable interest rates are low compared to fixed rates and fixed rates are expected to fall. The upper limit has also been set with debt restructuring in mind.

c. *Maturity structure of borrowing.* Upper and lower limits on proportion of fixed interest loans that mature in:
   - Under 12 months;
   - Between 12 months and 24 months;
   - Between 24 months and 5 years;
   - Between 5 and 10 years;
   - Between 10 and 20 years
   - Between 20 and 30 years
   - Between 30 and 40 years
   - Between 40 and 50 years

   The limits have been set to allow flexibility to manage loan durations but also to avoid having too much exposure to maturing loans in any period.

d. *Total investments.* The limit proposed allows flexibility for either external managers or the in-house team to lend for longer periods than one year if interest rates make this advantageous. The limit has been reduced to £40m to reflect lower balances.

Table 11.4 Prudential Indicators for Treasury Management

	2009/10	2010/11	2011/12	2012/13	2013/14
Treasury Management Code adopted	Yes	Yes	Yes	Yes	Yes
Exposure to interest rate changes: Upper limit on fixed rate interest (% of net borrowing)	100%	100%	100%	100%	100%
Upper limit on variable rate interest (% of net borrowing)	40%	40%	40%	40%	40%
Maturity of fixed interest loans:					
Under 12 months: o Upper limit o Lower limit	40% 0%	40% 0%	40% 0%	40% 0%	40% 0%
Between 12 and 24 months: o Upper limit o Lower limit	20% 0%	20% 0%	20% 0%	20% 0%	20% 0%
Between 24 months and 5 years: o Upper limit o Lower limit	20% 0%	20% 0%	20% 0%	20% 0%	20% 0%
5 to 10 years: o Upper limit o Lower limit	60% 0%	60% 0%	60% 0%	60% 0%	60% 0%
10 to 20 years: o Upper limit o Lower limit	100% 30%	100% 30%	100% 30%	100% 30%	100% 30%
Upper limit on Investments of more than one year:	£60m	£40m	£40m	£40m	£40m

Debt Restructuring

11.25 Many long-term loans were borrowed from the PWLB during periods when interest rates were high. The regulations under which such loans were given prevent their repayment without incurring substantial premia 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.

11.26 Market loans known as LOBOs (Lenders Option, Borrowers Option) are long-term loans (up to 70 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 without incurring a penalty. Local authority debt is regarded as of high quality to lending institutions that are keen to grow such business on their loan books. To date Brent has taken 13 LOBOs, valued at £85.5m. The council may take more LOBOs if opportunities arise, subject to limiting council's exposure to potential increases during the period of the loan.

11.27 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.

11.28 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 fewer opportunities to restructure. At present the council's main lender, the Public Works Loans Board (PWLB), has changed its terms to charge a larger premium on debt repaid prematurely. However, the PWLB is reviewing its repayment terms in 2010, which may facilitate more restructuring activity.

Member Engagement

11.29 Before 2008, two Treasury Management reports were made each year, unless important issues arose. The reports were the Strategy report, when setting the budget, and the Outturn report at year end. However, since the collapse of Lehman Brothers and the default of the Icelandic banks, there have been reports on lending activity to each meeting of the Audit Committee, setting out deposits at the end of each quarter and how the lending list has changed over the period. Other papers have detailed the report of the Commons Select Committee on local authority lending to Icelandic banks, the revised CIPFA Treasury Management Code of Practice and the DCLG Guidance on local authority investments.

11.30 The revised CIPFA Treasury Management Code of Practice makes some changes to previous practice, as follows:-

a) A mid-year review of the annual treasury strategy, looking at activities undertaken and any variation from agreed policies / practices.
b) The Audit Committee is to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

c) The Director of Finance and Corporate Resources is to ensure that members tasked with treasury management responsibilities have access to appropriate training opportunities

As part of this, it is proposed that this treasury management strategy and the annual investment strategy are considered by the Audit Committee at its meeting in March 2010. A full report on the new CIPFA Treasury Management Code will be made to members as soon as possible.