SECTION 10

10. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2012/13

Introduction

10.1 This section of the report presents:

a. The 2012/13 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b. The 2012/13 Annual Investment Strategy setting out the security of the investments made by the authority.

10.2 Under the Local Government Act 2003, local authority borrowing is regulated 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

a) The Treasury Management and the Annual Investment Strategies for 2012/13 as part of the main recommendations to the report.

Regulatory Requirements

10.4 The 2011 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.

10.5 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.

10.6 The Department for Communities and Local Government (DCLG) issued revised Guidance in 2010 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. The main points in the Guidance are:-

a) Security and liquidity are the key issues in lending. There should be 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 such as research and credit default swaps.
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 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.

The proposed Annual Investment Strategy for 2012/13 is attached.

Economic Background

10.7 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 (the UK economy shrunk by 4.5%), low interest rates (UK 0.5%) and stock market recovery (up by 50% since the trough in March) were the main features. In 2010, growth resumed and stock markets rose. In 2011, growth slowed and the overall situation was as follows:-

a) Economic growth was positive, but slowing in Europe (around 1%) and the UK (around 0.8). The World economy grew by around 3.5% - 4%.
b) Stock markets fell by around 5% - 10%. Sentiment was affected by the Japanese earthquake, and concerns about the euro area.
c) In UK, house prices were roughly stable, rising in London and the South East but falling elsewhere. Commercial property prices continued to recover during the year.
d) Despite the previous recession and low wage increases, UK Consumer Price Inflation rose by an estimated 4.3% in 2011, driven by rising commodity prices, an increase in VAT and the previous decline in the value of sterling.
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. Longer term rates have been held down by a flight to safety and quantitative easing in UK and USA.

10.8 Looking ahead to the next financial year, it is expected that world economic growth will slow further to around 3% - 3.5% in 2012, led by growth in emerging economies such as China and India (6% - 8%) but restrained by lower growth in developed countries. Although the USA economy should grow by around 2% - 2.5% in 2012, it is anticipated that UK and Europe may be close to, or may even fall into, recession. Interest rates should continue to be very low – UK Bank Rate may remain at 0.5% through to 2014. Inflation should fall sharply to around 2% - 3% by year end, possibly lower as low pay increases (around 2% per annum in the year to December), unemployment and unused capacity reduce pressures. The government is likely to continue with economic stimulus measures such as Quantitative Easing, and could raise the amount under this programme from the current £75bn to as much as £500bn over the next 12 – 18 months. Long-term interest rates are likely to remain low as high saving rates in Asia, low demand and quantitative easing programmes continue. However, the government has increased interest rates charged by the Public Works Loans Board, so that any council borrowing will be more expensive than gilt yields.

Financial Market Background

10.9 As said above, the credit crunch of 2007 – 2009 led to the collapse of a number of banks. However, the collapse of Lehman Brothers – a key broker and investment bank – in September 2008 caused a financial tsunami to overrun the banking system. Concerns about the security of financial systems has led Brent to continue to restrict its Lending List to UK institutions.

10.10 The turmoil in 2008 caused three Icelandic banks to be 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 £6.5m returned by the administrators of Heritable Bank, who suggest that depositors should recover around 86% - 90% of their original sum. It is anticipated that the £5m deposited with Glitnir will be returned early in 2012 following a favorable decision from the Icelandic Supreme Court. To date, Brent Council has paid £53,000 in legal expenses to facilitate recovery of the Glitnir deposit.

10.11 In the light of the crisis on the financial markets, the Lending List agreed by the Director of Finance & Corporate Services was reconstructed to reduce risk by the removal of foreign and lower rated UK banks, and Building Societies. In March 2009 and October 2010 the council made early repayment of loans from the PWLB valued at £64.75m and £50m., thus generating substantial savings (£2.2m per annum) and reducing balances available to deposit with other banks (currently at very low interest rates). The repayments have reduced council long term borrowing (currently £604.5m), well below the anticipated level of the Capital Financing Requirement at the end of financial year 2011/12.

Lending Policy

10.12 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.

10.13 Table 10.1 indicates the projected summary cash flow for the authority. Note that long term borrowing as at 31st March 2012 has been reduced to take into account the repayment of around £200m housing debt by the DCLG. It is anticipated that cash balances will be approximately £21m by 31st March 2013 based on the forecasts in Table 10.1 below.

Table 10.1 - Cash Flow Summary 2012/13

	£m		£m
Balances as at 1 April 2012			**10**
Capital programme	(102)		
Debt repayment (including premia)	(4)		
			(106)
			(96)
Capital receipts/grants	36		
Payment of debt premia	5		
Long-term borrowing	56		
Short term borrowing	-		
Minimum Revenue Provision	10		107
Cash Balances as at 31 March 2013			**21**
Total long-term borrowing as at 31.03.12			**405**

10.14 In 2011, a number of countries and banks have been downgraded by the credit rating agencies in recognition of debt and capital reserve issues. Officers have reacted to advice by suspending and removing both banks and the only building society from the Lending List, and reducing duration to one month (from one year). However, the removal of all but two banks (one of these is currently only used for overnight deposits) has led to increased used of the Debt Management Office at very low yields. As diluting credit quality would be dangerous, it is proposed that:-

a) Additional money market funds are added to the List, but with lower lending limits (usually £5m, rather than £12m previously).
b) Overseas banks of the requisite credit quality in countries that have AAA / A+ credit ratings, be added to the List. The countries involved are Canada, USA and Australia.

The proposed revised list is as shown in Table 10.2 below.

Table 10.2 – Revised Brent Lending List

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

Rated AA- or above long, F1+ short term, B/C or above individual, 1 support. Up to one month
HSBC Bank
Santander UK Ltd (overnight only)

B. OVERSEAS BANKS – UP TO £8M for INDIVIDUAL BANKS or banking groups, within Australia, Canada and USA, subject to a country limit of 20% (£10m). Rated AA- or above long, F1+ short term, B/C or above individual, 1 support. Up to one month

Australia
Australia and New Zealand Group
Commonwealth Bank of Australia
National Australia Bank
Westpac Banking Group

Canada
Bank of Montreal
Bank of Nova Scotia
Canadian Imperial Bank of Commerce
Royal Bank of Canada
Toronto Dominion Bank

USA
JP Morgan Chase Bank

C. MONEY MARKET FUNDS –UP TO £5M

Rated AAA
Royal Bank of Scotland
Morgan Stanley Cash Fund (up to £2m only)
Northern Trust
Various new money market funds, as appropriate

D. DEBT MANAGEMENT OFFICE – NO LIMIT – up to one year
E. OTHER LOCAL OR GOVERNMENT AUTHORITIES – NO LIMIT - up to one year
F. 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.

10.15 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, as well as to seek independent credit research.

10.16 Details of the basis on which credit ratings are used are set out in Table 10.3 below.

Table 10.3 – 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.

10.17 As set out above, Bank rate is at 0.5% and expected to remain at that level during the year. Activity will be very cautious, lending for short periods only, and seeking to use Money Market Funds to add extra yield. However, reduced cash balances following previous restructurings will ensure that most cash is used for day to day cash flow purposes. The 2012/13 budget assumes that Brent will receive further payments from Heritable bank (£2m).

Borrowing Policy

10.18 Long-term interest rates have fallen during 2011/12, mainly as a result of quantitative easing and the flight to safety following the Euroland debt crisis. At present, 10 year yields are below 2%, and 50 year yields close to 3%. It is anticipated that long-term rates may fall marginally during 2012/13, but as rates are at historic lows the reduction is unlikely to be great unless there is major market turbulence. However, rates may rise if markets lose confidence in UK as a safe haven or if the economy begins to recover rapidly. The budget uses a prudent assumption of a mix of short term borrowing and some longer term borrowing.

10.19 Borrowing policy in 2012/13 will be determined by a number of factors:

a) The capital programme for 2012/13, including the new Civic Centre (£45M).

b) The cost of loans from the PWLB. Previously the PWLB charged local authorities a 0.15% margin over government gilt rate when they took loans. In October 2010, the margin was increased to 1%, increasing pressure on councils to reduce capital programmes, borrow from other sources and to use internal resources (balances) rather than borrow externally.

c) 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 had previously indicated that CFR has been the most economical level for the authority's long-term debt. 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 to the market. 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.

d) The need to borrow. The cash flow summary indicates a need to borrow in 2012/13.

e) Movements in interest rates during the year. The current 50 year gilt rate of 3.1% 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. Currently, market sentiment, savings in Asia, quantitative easing and capital margin requirements on banks are supporting low gilt yields.

f) The prudential limits to borrowing as agreed by Full Council (see Prudential Code section of the Budget Report, Section 11).

10.20 It is currently proposed to borrow a further £56m long term in 2012/13 for the 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.

10.21 The Department for Communities and Local Government (DCLG) has proposed a reorganisation of housing finance in 2012, involving the repayment of around £200m housing revenue account debt. The implications for the council are as follows:-

a) Repayment of around £200m debt in March 2012, reducing individual PWLB loans at no cost to the General Fund.
b) As the Housing Revenue account will own its debt, the establishment of three separate loans pools – existing debt, duly apportioned; new HRA debt; new General Fund debt. Interest will be charged on debt in line with standard accounting practice.
c) The Director of Finance & Corporate Services will continue to be responsible for all treasury issues, but will need to prepare and use a separate HRA business plan, and to take borrowing decisions solely on the basis of that plan.

Prudential Indicators

10.22 Under the revised Treasury Management Code issued in 2009, the treasury prudential indicators are to be included within the treasury management strategy report. Under the revised 2011 Code, an indicator is to be added to indicate whether or not the council is borrowing money in advance of need. The prudential indicators are as follows:

a. Adoption of the CIPFA Code of Practice for Treasury Management. This was (re)adopted by the Council in January 2012. Amongst other things, it requires publication of an annual treasury management strategy, a mid-year report and an outturn report.

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 in excess of one year.* The limit proposed allows flexibility for the in-house team to lend for longer periods than one year if interest rates make this advantageous. The limit has been set at £20m to reflect lower balances, but at present investment duration is limited to one month until markets regain confidence.

e. *Gross and net debt*. This sets upper limits on the proportion of net debt compared to gross debt for the forthcoming and the two following years, calculated as the amount of net debt expressed as a percentage of gross debt.

Table 10.4 Prudential Indicators for Treasury Management

	2011/12	**2012/13**	**2013/14**	**2014/15**	**2015/16**
TM 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	40%	40%	40%	40%	40%
Maturity of fixed interest borrowing:					
Under 12 months: ○ Upper limit ○ Lower limit	 40% 0%	 40% 0%	 40% 0%	 40% 0%	 40% 0%
Between 12 and 24 months: ○ Upper ○ Lower	 20% 0%	 20% 0%	 20% 0%	 20% 0%	 20% 0%
Between 24 months and 5 years: ○ Upper ○ Lower	 20% 0%	 20% 0%	 20% 0%	 20% 0%	 20% 0%
5 to 10 years: ○ Upper ○ Lower	 60% 0%	 60% 0%	 60% 0%	 60% 0%	 60% 0%
10 to 20 years: (**Note –** similar limits for 20–30, 30–40 and 40–50 years) ○ Upper ○ Lower	 100% 0%	 100% 0%	 100% 0%	 100% 0%	 100% 0%
Upper limit on Investments of more than one year:	£20m	£20m	£20m	£20m	£20m
Upper limits on the proportion of net debt compared to gross debt, expressed as a percentage.	100%	100%	100%	100%	100%

Debt Restructuring

10.23 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.

10.24 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 15 LOBOs, valued at £95.5m. The council may take more LOBOs if opportunities arise, subject to limiting council's exposure to potential increases during the period of the loan.

10.25There 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.

10.26 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.

Member Engagement

10.27 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.

10.28 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 to Full Council, 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 Services is to ensure that members with treasury management responsibilities have access to appropriate training opportunities

As part of this, a training session for members was held in 2011.