SECTION 11

11. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2009/10

Introduction

11.1 This section of the report presents:

a. The 2009/10 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b. The 2009/10 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 the Treasury Management and the Annual Investment Strategies for 2009/10 as part of the main recommendations to the report. The main proposals to amend the lending list are set out in paragraph 11.18; proposals to limit borrowing and thereby cash available to lend are set out in paragraph 11.22; proposals for additional reporting to Members and for Member training are set out in paragraphs 11.28 and 11.29 respectively.

Regulatory Requirements

11.4 The 2002 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 proposed AIS for 2009/10 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

11.7 The international economic background has continued to be volatile, initially with rising oil and commodity prices, rising inflation and a credit crisis that has led to the collapse / takeover / rescue of various banks as inter bank lending and the wider provision of credit have reduced. The main features are:-

a) Economic growth has slowed sharply. For example, the European economy grew by 2.5% in 2007 (UK 3%), but only by 1% in 2008 (UK 0.8%).

b) Stock markets have fallen in anticipation of a recession. In UK, the market fell by 30% in 2008, Japan fell by 40%, Germany by 40%.

c) House and property prices fell throughout the year – the Halifax index records a fall of 16% in house prices.

d) Inflation rose on the back of record oil and commodity prices. In UK, The Index of Consumer Prices (CPI) rose by 5.25% in the year to September. However, inflation rates have now begun to fall as growth and consumer demand falter.

e) Interest rates have fallen as Central Banks became concerned about falling asset / property prices, bank stability and an anticipated recession. For example, USA rates have fallen from 3.5% to 0.5%, UK from 5.5% to 1% and ECB from 4% to 2%. Longer term rates have also fallen to below 4% in UK as markets became concerned about the prospect of deflation, but recently rates have risen as markets worried about sterling, gilt supply and longer term inflation.

11.8 Looking ahead to the next financial year, it is expected that world economic growth will continue to slow to around 2% in 2009, supported by growth in emerging economies such as China but reduced by declining activity in developed economies such as USA (-2%), UK (-2.5%) and Europe (-2%). It is anticipated that UK and Europe will continue in recession in 2010, though USA should start to recover. Interest rates should continue to be very low – UK Bank Rate may fall below 1% as the government resorts to unorthodox policies to induce bank lending and economic recovery. It is also likely that LIBOR / LIBID[1] rates will gradually reduce towards Bank Rate as the wholesale market and inter-bank lending recover. It is expected that the authorities will have few worries about inflation – RPI inflation is expected to become negative in 2009. Long-term rates are difficult to forecast – there could be pressure for rates to rise as governments borrow money to fund recovery programmes and the costs of nationalising / recapitalising banking

[1] LIBOR (the London Inter-Bank Offer Rate) is the rate at which banks lend to each other. LIBID (the London Inter-Bank Bid Rate) is the rate at which banks borrow from each other.

sectors. However, it is more likely that declining economic activity and consumer demand, and unorthodox central bank activities, will combine to reduce long term rates. It is anticipated that some central banks will use policies of 'quantitative easing' to increase money supply and reduce the dangers of continued deflation. However, over the longer term, this may lead to higher inflation.

Financial Market Background

11.9 During 2007, markets were badly affected by the impact of the sub-prime crisis in the USA, to the extent that the inter-bank (or wholesale) lending market ceased to function properly as financial institutions worried about the vulnerability of other banks to debt. Inter-bank rates (LIBOR and LIBID) rose well above ordinary bank rates. Northern Rock and other institutions that depended on the inter-bank market for short term funding were deemed to be vulnerable and collapsed into nationalisation / enforced takeover. In spring 2008, the collapse / takeover of Bear Sterns in USA encouraged governments to increase support through the supply of credit. A number of banks recapitalised through rights issues. As the USA developed its plans to buy up sub-prime debt (the TARP programme), the market began to assume that the credit shortage issues could be managed.

11.10 However, the collapse of Lehman Brothers – a key broker and investment bank – in September 2008 caused a financial tsunami to overrun the banking system. Confidence vanished, the inter-bank market reduced sharply in size, and a number of financial institutions had to be rescued particularly in Europe and USA – including HBOS, RBOS, Fortis, Dexia, FNMA, Freddie Mac, AIG, Merrill Lynch, Credit Suisse and others. Note that these were profitable institutions – but they could not borrow enough short term to meet withdrawals /short term liabilities.

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

The deposits have not yet been returned. The council is working with the Local Government Association and other local authorities to secure repayment in due course. If the loans are not returned, the lost interest in 2009/10 will be £150k (assuming an interest rate of 1%). The government has announced that it is amending regulations so that authorities need not make any provision in their 2009/10 budgets for any loss of Icelandic investments.

11.12 In the light of the continued turmoil on the financial markets, the Lending List agreed by the Director of Finance & Corporate Resources has been reconstructed to reduce risk – foreign and lower rated British banks have

been removed, lending has been short term and loans to building societies are closely scrutinised. Further details are provided below.

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 £74m by 31st March 2010 if the council maintains long-term borrowing at the Capital Financing Requirement.

Table 11.1 - Cash Flow Summary 2009/10

	£m	£m
Cash Balances as at 1 April 2009		**110**
Capital programme	(116)	
Debt repayment	(10)	
		(126)
		(16)
Capital receipts/grants	67	
Payment of debt premia	4	
Long-term borrowing	8	
Minimum Revenue Provision	11	
		90
Cash Balances as at 31 March 2010		**74**
Total long-term borrowing as at 31.03.09		**662**

11.15 As set out in paragraph 11.12, the Lending List has been reduced following the market turmoil in autumn 2008 (see Table 11.2 below). It is suggested that the revised list should remain in effect until the current problems in the inter-bank market – as represented in the wide spreads between LIBOR / LIBID and bank rate – are reduced and confidence is restored. It is also proposed to continue to lend short term – less than one month – until conditions are calmer. Both of these measures will reduce interest receipts, but income has previously been protected by a number of longer term deposits that will continue to run into 2009/10 and beyond. It is separately proposed to reduce the value of balances available to lend in recognition of the low returns available, by reducing borrowing below the Capital Financing Requirement (see paragraph 11.22).

Table 11.2 – Current Brent Lending List – 8th October 2008

A. UK BANKS – UP TO £10M

Rated AA- or above long, F1+ short term, B/C or above individual, 1 support

Abbey National PLC
Alliance & Leicester – linked with Abbey as part of Bank Santander
Bank of Scotland
Barclays Bank PLC
Clydedale Bank
HSBC Bank
Lloyds TSB
National Westminster
Royal Bank of Scotland – linked with Nat West as part of the RBOS group

B. BUILDING SOCIETIES– UP TO £10M

Investment grade ratings. Deposits are only made with authorisation from senior management.

Britannia
Chelsea
Cheshire
Coventry
Derbyshire
Dunfermline
Leeds
Nationwide
Newcastle
Norwich & Peterborough
Principality
Scarborough
Skipton
West Bromwich
Yorkshire

C. MONEY MARKET FUNDS –UP TO £12M

Rated AAA

Royal Bank of Scotland
Gartmore

D. DEBT MANAGEMENT OFFICE – NO LIMIT

E. OTHER LOCAL OR GOVERNMENT AUTHORITIES (UP TO £12M)

F. SUPRANATIONAL INSTITUTIONS – UP T^O £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

11.16 Over the longer term there are operational difficulties in running a reduced lending list – there is a major dependence on the building society sector to take deposits – and a cost in foregone interest receipts. While interest rates are low, the loss is smaller – for example, an overnight loan to the Debt Management Office (regarded as risk free) will return around 0.75%, whereas a one month loan to a building society will earn around 1.4%. When rates recover to more normal levels, around 5%, the gap tends to be larger. It is proposed to extend the list when the Interbank spread between 3 month LIBID and Bank Rate, which is currently around 0.65%, has fallen to around 0.25%, and further confirmation of 'normalisation' has been obtained from market participants and our treasury adviser, Butlers.

11.17 The Lending List which existed prior to 8th October sought to control risk by using up to four credit ratings issued by the credit rating agencies (long term, short term, individual and support) and to spread risk by setting maximum amounts that could be lent to individual institutions. The List was constructed in consultation with our treasury adviser and placed particular emphasis on high quality institutions with good short-term and support ratings. Details of the basis on which 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.

11.18 The financial turmoil has indicated areas in which the approach we have previously adopted can be improved, as follows:-

a) Whereas most countries were able to support their banks when they required short term finance, Iceland did not gain help from elsewhere and placed banks in administration. This compares with the situation with Fortis bank, in Belgium, where support was organised on a regional basis involving Belgium, Luxembourg, Holland and France. The revised list will include sovereign ratings, linked to the country of ownership, to the level of AA (a strong capacity to meet its financial obligations) and above. 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 credit default swaps and other indicators will be investigated further as to whether or not these can give early warnings about individual institutions or countries. It should be noted that credit default swaps have been available as an indicator to the credit rating agencies, but there are concerns that other factors make them erratic.

e) Ratings will remain as at present for building societies (investment grade – closely regulated), government and local government institutions, and supranational institutions supported by international bodies (only used, and rarely, by external managers). However, to ensure that risk is spread, no more than 50% of in-house deposits will be lent to the building society sector.

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, as in the cases of RBOS, Northern Rock, Abbey, Lloyds TSB, HSBC, and Standard Chartered.

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, but only with senior management approval.

11.19 At present, the investment company, Aberdeen Asset Management, manages an external portfolio valued at £22m, whereas the in-house manager has around £100m. 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 is allowed to use certificates of deposit, supranational bonds, government gilts and cash to enable them to improve performance, with a target of outperforming their benchmark by 0.5% per annum. Aberdeen underperformed in 2006/07 and 2007/08 as rising interest rates and a moderated interest rate cycle made it difficult for managers to add value. The current year to date has been different – the manager has outperformed substantially (Aberdeen 5.7%, benchmark 3.5%, for the nine months to 31st December 2008). It is felt prudent to retain external managers with different benchmarks, encouraging diversification.

11.20 As set out above, rates are at 1% and are expected to remain at that level or below throughout the year. In-house lending has previously sought to improve returns by lending for longer periods, but lending is currently on a short term basis using a more restricted list. Opportunities may improve when the current uncertainty ends and a new list is in place. The budget assumes that the deposits to Icelandic banks will neither be returned nor pay interest during 2009/10.

Borrowing Policy

11.21 Long-term interest rates have fallen to around 4.5% during 2008/09. It is anticipated that long-term rates may fall further in 2009/10, but there are conflicting pressures. The government may seek to reduce rates for borrowers, and stimulate recovery, by buying up debt (including government debt). As against this, the huge gilt issuance required to fund the fiscal deficit and the support of banks may force governments to pay higher rates. The budget uses a prudent assumption of an average interest rates of 5%.

11.22 Borrowing policy in 2009/10 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 2009/10 a further £8m new debt would be required in line with the CFR. However, whereas previously the interest rate curve has 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. This will also reduce credit risk. 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 2009/10 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, 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).

11.23 Unless there are opportunities to borrow early, it is proposed to borrow a further £8m in 2009/10 for the main capital programme. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

Debt Restructuring

11.24 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.

11.25 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. 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.

11.26 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.

11.27 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, has changed its terms to charge a larger premium on debt repaid prematurely. Unless interest rates rise and become much more volatile, debt restructuring may remain uneconomic.

Member Engagement

11.28 Previously two Treasury Management reports have been made each year, unless important issues have arisen. These have been the Strategy report, when setting the budget, and the Outturn report at year end. However, the economic turmoil since 2007, and the delay in recovering deposits from Icelandic banks, necessitates more regular reports. It is suggested that the following basis is followed:

a) Regular reports to the Executive on lending activity, setting out deposits at the end of each quarter and how the list has changed over the period. This report will also examine any other important events, such as a review of the Code governing Local Authority Lending, or any proposed changes to lending criteria.

b) If there is any change in the status of the outstanding deposits with Icelandic banks.

c) Regular updates to the Audit Committee and Performance and Finance Select Committee at intervals to be agreed with the Chairs.

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 on 4th March 2009.

11.29 It is also proposed that Members be offered a training session/s outlining the main aspects of the Treasury Strategy. The training will seek to be practical in nature – dealing with 'what should Members look for' – and would cover:

a) The regulatory background.

b) Economic background

c) Sources of advice and economic intelligence, and the role of the treasury adviser, Butlers.

d) Lending policy, including the Lending List, cash flow, duration of deposits, and the role of the external manager.

e) Borrowing policy, including sources of finance and the Capital Financing Requirement.

f) Debt restructuring

g) Reporting arrangements and Prudential requirements.