SECTION 8

8. TREASURY MANAGEMENT STRATEGY 2004/05

Introduction

8.1 This section of the report presents the 2004/05 Treasury Management Strategy that sets out the proposed borrowing and lending policy and the factors that will influence this over the coming year.

8.2 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 This has now been replaced by the Prudential Code, details of which are set out in Section 9 of the Budget report.

8.3 Members are asked to agree the Treasury Management Strategy for 2004/05 as part of the main recommendations to the report.

Treasury Management Strategy 2004/2005

8.4 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

8.5 The international economic background has been of rising stock markets in response to the removal of uncertainty (war in Iraq), low interest rates, and rising economic activity. Interest rates remain low - The Federal Reserve rate in USA is 1%, UK base rate has increased marginally to 3.75%, and the European Central Bank rate is 2%. It is anticipated that rates will not fall further, with the possible exception of Europe, where the euro has risen substantially. The largest economy is that of the USA, where growth has recovered sharply (annualised growth rate 8.2% in the third quarter of 2003) with a further package of tax cuts planned. Although activity in Europe is sluggish, other economies are enjoying healthy growth. Such synchronised growth is likely to lead to rising interest rates.

8.6 The UK scenario has been relatively benign. Increased government and consumer spending have supported activity so that unemployment has continued to fall. Low interest rates have fuelled sharp rises in house prices. GDP has grown by around 2.1% for 2003, below trend but in line with government forecasts and respectable when compared to other economies. It is estimated that growth has accelerated to around 0.9% in the fourth quarter of 2003. However, inflation as measured by RPIX has fallen to 2.5%, and to 1.3% as measured by the new Bank of England inflation measure, the Core Price Index (CPI – this excludes housing costs and council tax increases). Following a sharp fall caused by economic and military uncertainty, longer-term interest rates have risen as economic activity has recovered -10-year rates have risen from 4.5% to almost 5%.

8.7 Looking ahead to March 2005, there remains uncertainty and volatility in the Middle East. It is expected that world economic growth will accelerate, led by USA and Asia. However, USA short-term interest rates are not expected to rise in 2004, and other rates may remain low to support the recovery. On the gloomy side, if there is synchronised world growth, rates may rise earlier and faster than is desired in a presidential election year. In UK, the market anticipates that base rate will rise to around 5.25%. Other economic forecasters expect increases to be muted – around 4.5% by December 2004, rising to 5% in 2005. Pressures on rates include rising economic growth (3% in 2004), personal debt, full employment, and public expenditure / borrowing. On the other hand, the use of CPI at 2% as a target may restrain rising rates. It is also anticipated that ten-year rates will rise to around 5.25%.

Lending Policy

8.8 The Table at the end of this Section indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £93m by 1st April 2005 as the authority maintains long-term borrowing at the capital financing requirement (see paragraph 8.12).

8.9 Two companies, Aberdeen Asset Management and Morley Fund Management, manage external portfolios valued at £11m and £23m respectively under arrangements broadly established in 1998. The managers are allowed to use certificates of deposit, government gilts and cash to enable them to improve performance. Both managers outperformed their benchmarks in 2002/03. 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. The findings were favourable – both processes and people gave reasons for confidence - and Aberdeen has outperformed the benchmark for 2003/4 to date. More recently concerns have arisen over the performance and investment approach followed by Morley, so that a review of the external management arrangements is planned. 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.

8.10 As set out above, it is expected that rates will rise during the year from the current base rate of 3.75%, probably to around 4.5% - 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. The policy will be subject to constant review as fresh data becomes available.

Borrowing Policy

8.11 Long-term interest rates have risen in 2003 as markets have recovered and economic growth strengthened. It is anticipated that long-term rates will rise marginally during 2004/05.

8.12 Borrowing policy in 2004/05 will be determined by a number of factors:

(a) The Capital Financing Requirement (CFR) replaces the credit ceiling, and is the difference between the authority's total liabilities in respect of capital expenditure financed by credit and the provision that has been made to meet those liabilities. 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 2004/05 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 move with 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 to ensure that maturities are spread.

(b) The need to borrow. The cashflow summary indicates a need to borrow in 2004/05. 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 credit ceiling.

(c) Movements in interest rates during the year. The current 10 year gilt rate of 5% 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 that long-term rates are currently low and may rise marginally.

(d) The Prudential limits to borrowing as agreed by the Council (see Prudential Code section of the Budget report, Section 9).

8.13 It is therefore proposed to repay maturing debt during 2003/4 (£90m) maintaining a portion 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

8.14 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. However, £170m has been repaid or restructured since June 1999, with premia charged to the Provision for Credit Liabilities or financed through market loans known as LOBOs (Lenders Option, Borrowers Option). Restructuring activity increased sharply in 2003/4 following a change in regulations that allowed more flexibility to charge premia to the Housing Revenue Account. The council repaid £66.6m at an average rate of 10.24%, and borrowed £55m at variable rates and £15m through LOBOs.

8.15 LOBOs 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. Falling interest rates, particularly in USA, have led to opportunities to take LOBOs at favorable rates. To date Brent has taken eight LOBOs, to the value of £55.5m. The council may take more LOBOs if opportunities arise, but the current level of exposure will only make new loans attractive at low rates.

8.16 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.

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

Local Government Investments – Revised Regulations

8.18 The Office of the Deputy Prime Minister (ODPM) is currently consulting interested parties on revisions to regulations prescribing the investment of council balances. It is anticipated that authorities will be able to use a wider range of financial instruments – but not equities – but that Full Council will be required to approve an Annual Investment Strategy. The Strategy will be part of – but distinct from - the Treasury Management Strategy required under the CIPFA Code of Practice.

8.19 The ODPM has suggested that the Annual Investment Strategy (AIS) will set out the types of investments that may be held during the year, exposure limits and procedures for credit ratings. There may also be reference to the need to obtain professional advice. It is likely that a further report will be brought forward on the AIS, especially as the previous Approved Investment Regulations cease to have effect from 1st April 2004.

Cashflow Summary 2004/2005

	£m	£m
Cash Balances as at 1 April 2004		**98**
Capital Programme	(56)	
Debt Repayment	(90)	
		(146)
		(48)
Capital Receipts/Grants	11	
Increase in balances	2	
Long-term borrowing	124	
Minimum Revenue Provision	4	
		141
Cash Balances as at 31 March 2005		**93**
Total long-term borrowing as at 31.3.04		**478**