ITEM NO………..

LONDON BOROUGH OF BRENT Executive - 11th July 2005 Report from the Director of Finance and Corporate Resources	
For Decision	Wards affected: NONE SPECIFIC

Report Title: THE TREASURY MANAGEMENT ANNUAL REPORT 2004/05

Forward Plan Ref: BFS-05/05-3

1 SUMMARY

The report details treasury management activity and performance during 2004/05.

2 RECOMMENDATIONS

Members are asked to recommend the report to full Council.

3 DETAIL

3.1 Full Council adopted the 2002 CIPFA Code of Practice on Treasury Management in Local Authorities in September 2002. The Code stipulates that the Chief Financial Officer should set out in advance to Full Council the treasury strategy for the forthcoming financial year, and subsequently report the treasury management activities during that year. This report details treasury management activities during 2004/05.

3.2 Treasury management in this context is defined as ‘the management of the local authority’s cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of the optimum performance consistent with those risks.’ This means that the pursuit of additional returns must be placed within the framework of the prudent protection of the council’s cash balances and a rigorous assessment of risk.

3.3 The introduction of the new prudential system of borrowing in the 2003 Local Government Act (LGA) gave new opportunities for councils to assess their requirements for capital spending, and not have them restricted by nationally set credit approvals, as previously. The new system also brought new responsibilities on councils to ensure that:

a) capital expenditure plans are affordable;

b) all external borrowing and other long term liabilities are within prudent and sustainable levels;

c) treasury management decisions are taken in accordance with good professional practice.

3.4 Under regulations issued under the 2003 LGA councils are required to follow the Prudential Code issued by CIPFA which sets out how councils ensure responsible use of new freedoms. The Code details indicators that councils are required to set before the beginning of each year, to monitor during the year, and to report on at the end of each year. Regulations also establish that councils are required to agree an Annual Investment Strategy (AIS) before the beginning of each year, setting out how investments will be prudently managed with close attention to security and liquidity. The AIS for 2004/05 was agreed by Full Council in June 2004, and has note required amendment.

ECONOMIC BACKGROUND DURING 2004/05

3.5 2004 was a year of strong economic growth – GDP in UK rose by 3.1%, and in USA by 4%. As growth continued, policy makers were concerned about inflation rising as low interest rates led to overheating in house prices and consumer demand / debt. The sharp rise in oil and commodity prices have also led to inflationary concerns. Although both the European Central Bank and the Bank of Japan have maintained rates to stimulate weak economies, at 2% and 1% respectively, both UK and USA have seen rising short rates in 2004/5 – UK from 4% to 4.75%, USA from 1% to 2.5%.

3.6 Long-term interest rates rose and fell during the year. Initially markets anticipated rising short rates – towards 5% - 5.5% on concerns about inflation, consumer expenditure and house prices – and a correction in long rates to more 'normal' levels. However, slowing consumer expenditure and house price rises in 2005 evidenced that the UK economy was growing at trend level, reducing the requirement to raise rates. Other factors are also apparent – the deflationary effects of the growth in Asian industrial production, and the high level of Asian savings – which may keep long-term interest rates low. Currently (June 2005) 25 year rates have fallen to 4.4%. The table below shows ten and twenty-five year Public Works Loans Board (PWLB) rates during the year.

Table 1 – PWLB Interest rates during 2004/5

	31 March 2004 %	**30 June %**	**30 Sept. %**	**31 March 2005 %**
10 year	4.95	5.3	4.95	4.85
25 year	4.8	5.05	4.8	4.8

STRATEGY AGREED FOR 2004/05

3.7 On the basis of advice from economists and in-house research, the Treasury Management strategy anticipated that base rate would rise to 4.5% - 5% in 2004/5. It was expected that in-house balances would fall marginally, but that loans would be for longer periods when it was felt that the market was too pessimistic about rising rates. The borrowing strategy assumed that long-term rates would rise marginally during 2004/5 (to 5% - 5.25%). It was therefore agreed to borrow at both fixed and variable rates, to maintain debt at the authority's Capital Financing Requirement (CFR) and to take advantage of debt restructuring opportunities. (The Capital Financing Requirement – previously known as the credit ceiling - 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 our treasury adviser, Sector, indicates that it is the most economical level for the authority's long-term debt.)

OUTTURN 2004/05 - PRUDENTIAL CODE

3.8 The outturn for the Prudential Indicators of Affordability (looking at capital financing charges as a proportion of net revenue and the impact of unsupported borrowing on council tax) and Capital Spending (the capital spending programme and the capital financing requirement) are set out in the Capital Expenditure report for 2004/5. The CFR for 2004/5 was expected to be £500.7m, the actual was £501.1m. The Prudential Indicators for External Debt were as follows:-

Indicator	Limit	Status
Authorised limit for external debt	£850m	Met
Operational boundary for external debt	£650m	Met
Net borrowing	Below CFR	Met

3.9 The authorised limit for external borrowing is set flexibly above the CFR to allow for opportunities to restructure debt or borrow early when interest rates are favourable. The Operational Boundary sets out the expected maximum borrowing during the year, again allowing for cash flow, interest rate opportunities and possible restructuring. Net borrowing – gross borrowing less investment – should not exceed the CFR apart from in the short term. This is to ensure that net borrowing is only used for capital purposes.

3.10 The Prudential Indicators for Treasury Management were as follows:-

Indicator	Limit	Actions
Treasury Management Code		Adopted in 2002
Exposure to interest rate changes		
- fixed rate upper limit	100%	96%
- variable rate upper limit	40%	19%
Maturity of fixed interest loans		
Under 12 months		
- upper limit	40%	2%
- lower limit	0%	1%
12 months – 24 months		
- upper limit	20%	-
- lower limit	0%	-
24 months – 5 years		
- upper limit	20%	5%
- lower limit	0%	5%
5 years – 10 years		
- upper limit	60%	15%
- lower limit	0%	6%
Above 10 years		
- upper limit	90%	74%
- lower limit	30%	70%
Upper limit on investments of more than one year	**£50m**	**£1.4m**

3.11 The various treasury management indicators have been met. They have been set to ensure that interest rate exposures are managed to avoid financial difficulties if interest rates rise sharply. Although borrowing at variable rates can be advantageous if rates are falling, a sharp rise can cause budget difficulties, and force the council to fix rates at an inopportune time. Again, managing loan durations ensures a variety of maturity dates to avoid concentration when rates may be high. Finally, the upper limit on investments of more than one year allows flexibility to lend for longer periods if interest rates make this advantageous, particularly by external managers investing in gilts, but ensures that balances are available for cash flow purposes. As interest rates were rising during 2004/05, there has been little long-term lending.

OUTTURN 2004/05 – TREASURY MANAGEMENT

3.11 The Council's treasury portfolio as at 31 March 2005 was as follows:-

	31.3.04	31.3.2005	
	Actual £m	**Planned £m**	**Actual £m**
Fixed rate loans – PWLB	338.1	427	411.3
Variable rate loans – PWLB	89.8	25	20
Variable rate loans - Market	50.5	60	65.5
Short-term loans - Market	17.5	-	-
Total Debt	**495.9**	**512**	**496.8**
INVESTMENTS	**74.9**	**93**	**66.9**
NET DEBT	**421.0**	**419**	**429.9**

3.12 Balances available for investment fell as the capital programme approved for Brent Housing Partnership was implemented (Note that Brent Council was able to borrow in 2003/4 at a variable rate of 3.96% to fund the programme). The average rate of interest payable by Brent Council fell from 7.34% in 2003/4 to 6.47% in 2004/5, mainly because in 2003/4 the authority was able to take advantage of regulatory changes governing the charging of early redemption premia to undertake major debt restructurings. In 2004/5 Brent Council has restructured long-term debt and taken out new loans as follows:

a) Borrowing £15m market loans (known as LOBOs – or Lenders Option, Borrowers Option). These loans are fixed at an average rate of 4.65% for an initial period (5 years), following which the lender may request a change to the rate. If this happens, the borrower may repay the loan rather than pay the increase.

b) In addition, £20m debt at an average rate of 7.25% was replaced by variable rate debt, currently at 4.9%.

Temporary borrowing was concentrated towards the end of 2004/5, after base rates had risen, at an average rate of 4.62%.

3.13 As at 31st March 2005, the longer-term debt portfolio (**excluding any short term debt**) was as follows:

Maturing Within	**£m** **31.03.05**	**31.03.04**	**2005 %**	**Average Interest Rate 2004/5 %**
1 Year	10.0	(6.9)	2.0	4.55
1 – 2 Years	-			-
2 – 3 Years	9.5	(-)	1.9	9.04
3 – 4 Years	15.0	(9.5)	3.0	8.00
4 – 5 Years	-	(15.0)	-	-
5 – 6 Years	-	(-)	-	-
6 – 10 Years	77.0	(27.0)	15.4	9.41
10 – 15 Years	12.5	(70.0)	2.9	9.38
Over 15 Years	287.3	(209.7)	57.7	5.97
Variable - PWLB	20.0	(89.8)	4.0	4.94
Variable – Market	65.5	(50.5)	13.1	4.90
TOTAL	**496.8**	**(478.4)**		

3.14 The in-house team has lent a total of £263m (2003/4 £631m) at rates between 4.125% and 5.45%, and at an average rate of 4.58%. The total lent fell sharply, reflecting lower balances available for investment. The lending strategy followed was to lend money for short periods, then seek opportunities to lend for longer as the market anticipated sharply rising interest rates. The highest rate was achieved as a result of lending ahead of the date on which the deposit was made. Economic research and advice from Sector indicated that rates would rise steadily rather than sharply. Loans were made to high quality counterparties included on the Treasury Lending list.

3.15 Other budgetary details for 2004/05 were as follows:

	Budget £m	**Actual £m**
Interest paid on external debt	34.0	32.5
Interest received on deposits	2.4	3.3
Debt management expenses	0.3	0.3

The reduced interest paid reflects an increase in average debt outstanding during the year, offset by savings arising from debt restructuring and reduced borrowing costs. The savings accruing to the General Fund from the lower interest paid are reduced by the share of debt pertaining to the Housing Revenue account (55%), so that the General fund gained a net 0.7m. The additional interest received on deposits – which is all payable to the General Fund - reflects the decision to borrow early and the cautious view of interest rates taken in preparing the budget.

EXTERNAL CASH MANAGERS

3.16 External cash managers were appointed in 1998 to manage two portfolios with the aim of achieving an improved return (0.5% above the benchmark) at an acceptable level of risk. Morley Fund Management replaced Dresdner in 2002 when the latter exited the treasury management business, but was replaced by Alliance Capital Management in December 2004 following a period of erratic performance. The value of the Morley's portfolio was £18.7m as at 31st March 2005, whereas Aberdeen's was £18.4m. Actual performance for 2004/05 (2003/04 in brackets), and the three and five years to 2004/5 has been as follows: -

	Aberdeen %	Dresdner/ Morley/ Alliance %	Brent in-house %	7 Day LIBID Benchmark %
2004/2005	4.69 (3.7)	4.57 (3.48)	4.58 (3.88)	4.58 (3.63)
Three Years	4.4	4.1	4.3	4.0
Five Years	4.9	4.8	4.8	4.5

3.17 Aberdeen marginally outperformed the benchmark in 2004/05. The manager used certificates of deposit in the year, locking into rising yields but not locking into gilt yields. Alliance has marginally outperformed a marginally different benchmark (a combination of gilts and cash) since appointment. The year was very difficult – rates were rising and concerns that gilt markets (the main area in which external managers can add value) had become overvalued and that the risk of capital loss had increased. The in-house team did not have access to the same wider range of lending instruments as the managers (gilts or certificates of deposit), but was able to add value by using money market funds or by lending on the money market for longer periods at appropriate times – in particular, by lending in advance when market expectations of rising, or even steady, interest rates had become unrealistic. However, cash balances fell as interest rates rose, thus reducing performance. The three and five year records indicate that managers have outperformed during the period, but not achieved their outperformance targets. However, both Aberdeen and Alliance are among the best managers over all periods, which have seen low and falling gilt yields.

DEVELOPMENTS SINCE THE END OF THE YEAR

3.18 The market anticipates that short-term interest rates have peaked and may fall during the remainder of 2005/06. However, the managers feel that rates will remain at 4.75% for some time. Longer rates have fallen. It is anticipated that there may be opportunities for debt restructuring in 2005/6, but only if long-term rates rise.

4 FINANCIAL IMPLICATIONS

As set out in the report, the Council reduced external interest paid in 2004/05 (down from £35.2m in 2003/04 to £32.5m) following debt restructurings. Interest on cash balances also rose during the year (up from £3m in 2003/4 to £3.3m) as interest rates increased, offsetting lower balances.

5 STAFFING IMPLICATIONS

None.

6 DIVERSITY IMPLICATIONS

The proposals in this report have been subject to screening and officers believe that there are no diversities implications arising from it.

7 LEGAL IMPLICATIONS

There are no legal implications arising from this report.

8 BACKGROUND INFORMATION

Loans Register.

Logotech Loans Management System.

Sun Accounting Database.

Treasury Policy Statement.

Sector Quarterly and special reports on treasury management.

Morley Fund Management, Alliance Capital Fund Management and Aberdeen Asset Management quarterly reports.

Executive – Treasury Management Annual Report 2003/04 – 12th July 2004.

Executive – 2004/5 Budget Reports on Treasury Strategy and Prudential Code – February 2004

Executive - Annual Investment Strategy 2004/5 – 24th May 2004

If members wish to discuss any aspect of this report please contact the Exchequer and Investment Team, Room 115, Brent Town Hall (extension 1472/1474).

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