SECTION 11

11. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2007/08

Introduction

11.1 This section of the report presents:

a) The 2007/08 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b) The 2007/08 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 2007/08 as part of the main recommendations to the report.

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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 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

11.5 The international economic background has been benign despite rising oil and commodity prices and higher interest rates. Economic growth has continued to be strong – the largest economy, the USA, has grown by 3% in 2006, Europe by 2.5%, China and India by 7% - 10%. Stock markets have risen. The interest rate picture is more mixed - rates have risen but remain fairly low. The Federal Reserve rate in USA has risen to 5.25% (from 4.25%), the European Central Bank rate to 3.5% (from 2.25%), the UK Bank rate to 5.25% (from 4.5%), and Japanese rates to 0.25% (from effectively nil). Longer term rates remain very low – UK 10 – 50 year rates are around 4.3% - 4.6%, and European 10 year rates are 3.3% – as high savings in Asia, low cost production, reduced investment in developed countries, and pension fund investment in bonds combine to make credit readily available.

11.6 The UK scenario has been of rising growth and worries about inflation. The UK economy has grown by 2.6% in 2006, up from 1.6% in 2005, with further strong expansion anticipated in 2007. Inflation as measured by RPI-X has risen to 3.8% (from 2%), and to 3% (from 2%) as measured by the Core Price Index.1 Currently the market expects short term rates to rise next year to 5.5%, but further increases may be necessary to reduce demand and inflation.

11.7 Looking ahead to March 2008, it is expected that world economic growth will slow marginally. USA short-term interest rates are likely to remain at around 5.25% in 2007 (to reduce inflationary pressures), probably falling towards the end of the year. It is also anticipated that the European Central Bank may raise rates further, to 4.0% - 4.5%, to contain inflation and growth of the money supply. Japanese rates may rise marginally, but growth remains fragile and inflation is close to nil. In UK, the market anticipates that Bank Rate will rise to 5.5% to reduce inflationary pressures. The Bank of England is concerned that inflationary expectations may become entrenched and pay demands rise accordingly. Long-term rates are difficult to forecast – the savings glut and huge financial surpluses in Asia and the Middle East, deflationary pressures and pension fund activity may all combine to keep rates at very low levels, though it is expected that investment may rise. On the other hand, long rates are theoretically based on inflation (usually around 2.5%, but currently higher), a real rate of return (around 2.5% - 3%) and a risk premium (around 0.5%) – giving rates of around 6%. Experience suggests that current low rates are an aberration, but this could continue for some while.

Lending Policy

11.8 Table 1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £95m by 1st April 2007 as the authority maintains long-term borrowing at the capital financing requirement, but undertakes some borrowing in advance (£20m) for 2007/08 when rates are advantageous.

[1] The RPI-X is the Retail Price Index for all items but excluding mortgage interest. The Core Price Index (CPI) excludes all housing costs, including council tax.

Table 1 - Cash Flow Summary 2007/2008

	£m	£m
Cash Balances as at 1 April 2007		**95**
Capital Programme	(70)	
Debt Repayment	(10)	
		(80)
		15
Capital Receipts/Grants	26	
Payment of debt premia	5	
Long-term borrowing	43	
Minimum Revenue Provision	8	
		82
Cash Balances as at 31 March 2008		**97**
Total long-term borrowing as at 31.03.07		**589**

11.9 Two companies, Aberdeen Asset Management and Alliance Capital, manage external portfolios valued at £20m each. The managers are allowed to use certificates of deposit, supranational bonds, government gilts and cash to enable them to improve performance, with a target of outperforming their benchmarks by 0.5% per annum. Aberdeen has consistently outperformed the benchmark in previous years, but only marginally since 2003/04. The interest cycle has moderated in recent years allowing managers fewer opportunities to add value – gilts have offered few rewards. Alliance Capital was appointed at the end of 2004, and marginally outperformed a higher, gilt related, benchmark in 2005/06. Both managers have underperformed to date in 2006/07 against a background of rising interest rates. It is felt to be prudent to retain two managers with different benchmarks, encouraging diversification. However, the performance of Alliance has been disappointing and their mandate may be reviewed. The remaining balances are managed in house on the basis of a treasury lending list that uses standard credit ratings. The lending policy seeks to protect capital whilst generating interest payments to support the revenue budget.

11.10 As set out above, it is expected that rates may rise to around 5.25% / 5.5%. In-house lending currently seeks 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 become available.

Borrowing Policy

11.11 Long-term interest rates have fluctuated but ended roughly flat in 2006/07 (4.25% / 4.5%). It is anticipated that long-term rates will rise marginally in 2007/08, but remain low (around 4.5% / 4.75%).

11.12 Borrowing policy in 2007/08 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 adviser, Sector, has indicated that CFR is - at present - the most economical level for the authority's long-term debt. In 2007/08 a further £43m new debt will be required in line with the CFR, £20m of which has been taken in 2006/07 if rates are advantageous. If short-term interest rates reduce sharply, 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. However, it is expected that the remaining £23m will be taken for longer periods if low long term rates continue, allowing maturities to be spread and locking into low rates.

(b) The need to borrow. The cashflow summary indicates a need to borrow in 2007/08. 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 CFR.

(c) Movements in interest rates during the year. The current 10 year gilt rate of 4.6% 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 fall and that the risk premium is lower.

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

11.13 It is therefore proposed to borrow a further £23m in 2007/08. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

Debt Restructuring and Use of the Provision for Credit Liabilities

11.14 Many long-term loans were borrowed from the PWLB during periods when interest rates were very 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. Restructuring activity increased sharply in 2006/07 – helping to achieve a saving of £5.3m in interest payable on loans to the council and reducing the average rate of interest payable on debt from 6.3% in 2005/06 to 5.2% in 2007/08. Although the debt restructuring has incurred additional costs – in particular premia and interest on premia – the net result has allowed substantial savings to the revenue account.

11.15 Market loans known as LOBOs (Lenders Option, Borrowers Option) are long-term loans (up to 60 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, who are keen to grow such business on their loan books. To date Brent has taken 15 LOBOs, valued at £70.5m. The council may take more LOBOs if opportunities arise, subject to limiting council's exposure to potential increases during the period of the loan.

11.16 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.

11.17 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. It was feared that activity might be hampered by possible accounting changes under Financial Reporting Standard (FRS) 25 and FRS26, but it is anticipated that the Department of Communities and Local Government (DCLG) will issue regulations protecting current practice.

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Background

11.18 As part of the prudential framework established for capital finance in local authorities, the 1990 Regulations have been replaced by Guidance issued under Section 15 (1) (a) of the Local Government Act 2003. The Guidance is less prescriptive than the 1990 Regulations, but seeks to ensure that local authorities demonstrate sound procedures to manage treasury balances. The main points are as follows:

a) Authorities should adopt the CIPFA Treasury Management Code.

b) Prudence is fundamental. Authorities should seek the highest rate of return consistent with proper levels of security and liquidity.

c) Authorities should prepare an Annual Investment Strategy (AIS), to be agreed by Full Council before the commencement of each year.

d) The AIS will 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 will also set out the maximum periods for which funds may prudently be committed (liquidity).

e) 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 will not invest treasury balances in shares, corporate bonds or floating rate notes issued by companies.

Annual Investment Strategy

11.19 The proposed AIS for 2007/08 is attached as Appendix N, using a template produced by Brent's treasury adviser, Sector. Investments are categorised as either Specified or Non-specified Investments. The AIS is the same as that followed in 2006/07, that is:

a) Specified Investments (as set out in the Guidance) are those that offer high security and liquidity. Such investments will be in sterling, with a maturity of no more than one year, and will be made to bodies with high credit ratings – UK or local government, banks, building societies, money market funds, and supra-national institutions.

b) Non-specified Investments (as set out in the Guidance) are those that may either entail more risk or are more complex, such as gilts, certificates of deposit or commercial paper. In all cases where time deposits (loans with a fixed maturity date to banks, building societies etc) are not involved, external fund managers will take investment decisions within their Investment Management Agreements.