## SECTION 11

## 11. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2008/09

### Introduction

11.1 This section of the report presents:

a. The 2008/09 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b. The 2008/09 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 2008/09 as part of the main recommendations to the report.

### TREASURY MANAGEMENT STRATEGY 2008/09

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 volatile, with rising oil and commodity prices, (initially) higher interest rates, and the sub-prime lending debacle that has undermined credit markets. Economic growth has continued to be strong – the world economy has grown by 5% in 2007, Europe by 2.5%, UK by 3% and China by 11.5%. However, the USA economy has slowed sharply (below 2% growth) as the impacts of the sub-prime issue and falling house prices are felt. Stock markets are volatile but have not fallen. The interest rate picture is mixed – official rates remained high (USA at 5.25%) or rose (UK to 5.75%, ECB to 4%) but have begun to fall back (USA to 3.5%, UK to 5.5%) on fears that falling house prices, tighter credit and reduced consumer demand will lead to recession. Longer term rates initially rose but are once again very low – UK 50 year rates are around 4.3%, and European 10 year rates are 3.3%.

11.6 The UK scenario was initially of rising growth and worries about inflation. The UK economy has grown by 3% in 2007, up from 2.6% in 2006. Inflation as measured by RPIX has fallen to 3.1% (from 3.8%), and to 2.1% (from 3%) as measured by the Consumer Price Index. However, although there continue to be inflationary pressures in the pipeline from commodity and oil price rises, and concern about pay increases, worries about falling consumer demand, tighter credit and lower house prices have led to forecasts of sharply reduced economic growth of between 1.5% and 2% in 2008. On this basis, bank rate has been cut from 5.75% to 5.5%, and the Bank of England has reduced fears of a credit crunch by making more money available to markets.

11.7 Looking ahead to March 2009, it is expected that world economic growth will slow marginally to around 4.5%, supported by growth in emerging economies such as China. USA short-term interest rates are likely to fall to around 3.5% in 2008, though the European Central Bank may hold rates at 4.0% to contain inflation. In UK, the market anticipates that the Bank Rate will fall to around 4.5% to support the economy. 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. 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, with 50 year rates possibly rising to around 4.6%.

**Lending Policy**

11.8 Table 11.1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £100m by 1st April 2008 as the authority maintains long-term borrowing at the capital financing requirement, but undertakes some borrowing in advance (£10m) for 2008/09 when rates are advantageous. The cash flow summary also allows for the potential impact of property acquisitions as part of the overall accommodation strategy detailed in Section 10 above.

**Table 11.1 - Cash Flow Summary 2008/09**

| | £m | £m |
|---|---|---|
| **Cash Balances as at 1 April 2008** | | **100** |
| Capital programme | (49) | |
| Spending on property acquisitions | (25) | |
| Debt repayment | (-) | |
| | | (74) |
| | | 26 |
| Capital receipts/grants | 28 | |
| Payment of debt premia | 5 | |
| Long-term borrowing | 7 | |
| Borrowing for property acquisitions | 25 | |
| Minimum Revenue Provision | 9 | |
| | | 74 |
| **Cash Balances as at 31 March 2009** | | **100** |
| **Total long-term borrowing as at 31.03.08** | | **617** |

11.9 Until August 2007, two companies, Aberdeen Asset Management and Alliance Capital, managed external portfolios valued at £22m each and the in-house manager around £60m. The managers were 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. In 2007, following a period of poor performance and lost mandates, Alliance gave notice that the house was exiting the cash management business, so the fund was taken back in house. It is anticipated that £20m will be re-invested with one or more external manager, but with a different mandate. Aberdeen also underperformed in 2006/07 as rising interest rates made it difficult for managers to add value. It is also apparent that the interest cycle has moderated in recent years – gilts have offered few rewards, and then only briefly. It is felt to be prudent to retain two managers with different benchmarks, encouraging diversification. However, the performance of Aberdeen has been disappointing as the house was unable to 'lock into' gilts that would have retained high rates over the medium term. 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 fall to around 4.5%. The budget assumes an average lending rate of 4.75% over the year. In-house lending has sought 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.

11.11 During 2007, markets have been badly affected by the impact of the sub-prime crisis in America, to the extent that the inter bank market ceased to function. Northern Rock and other institutions were perceived to be vulnerable to serious liquidity issues, so the decision was taken early to remove four

institutions from the lending list until their situation became clear. These institutions remain off the Council's lending list.

### Borrowing Policy

11.12 Long-term interest rates have fluctuated but ended roughly flat in 2007/08 (4.25% / 4.5%). It is anticipated that long-term rates will rise marginally in 2008/09, but remain low (around 4.5% / 4.75%, though the budget uses a conservative assumption of 5%).

11.13 Borrowing policy in 2008/09 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 indicated that CFR is - at present - the most economical level for the authority's long-term debt. In 2008/09 a further £5m - £10m new debt will be required in line with the CFR. This may be taken in 2007/08 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.

b. The need to borrow. The cashflow summary indicates a need to borrow in 2008/09. 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 50 year gilt rate of 4.3% 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).

11.14 Unless there are opportunities to borrow early, it is proposed to borrow a further £5m - £10m in 2008/09 for the main capital programme. There may also be a need to borrow up to £25m to support property acquisitions as part of the council's overall office accommodation strategy, as set out in Section 10. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

### Debt Restructuring

11.15 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. Debt worth more than £100m has been restructured in 2007/08 – helping to reduce the average rate of interest payable on debt from 5.2% in 2007/08 to 5% in 2008/09. Although the debt restructuring has incurred additional costs – in particular premia and interest on premia – the net result has allowed substantial savings (£300,000 per annum) to the revenue account.

11.16 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, 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.

11.17 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.

11.18 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 will remain uneconomic.

## ANNUAL INVESTMENT STRATEGY 2008/09

### Background

11.19 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 except through pooled schemes.

**Annual Investment Strategy**

11.20 The proposed AIS for 2008/09 is attached as Appendix N. Investments are categorised as either Specified or Non-specified Investments. The AIS is the same as that followed in 2007/08, 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.