ITEM NO:

BRENT COUNCIL	**Executive** 4th August 2008 **Report from the Director of Finance and Corporate Resources**
	Wards Affected: None

The Treasury Management Annual Report 2007/08

Forward Plan Ref: F&CR-08/09-4

1. SUMMARY

The purpose of this report is to provide information to members on borrowing and investment activity during 2007/08. It also sets out how the council performed against prudential indicators set in the 2007/08 budget. Finally, it proposes the adoption of a new policy on provision for repayment of debt following changes to government regulations. Both the Treasury Management Annual Report and the policy on provision for repayment of principal need to be agreed by Full Council. The Executive is therefore asked to recommend the Annual Report and the new policy to Full Council for approval.

2. RECOMMENDATIONS

The Executive is asked to recommend that Full Council:

2.1 Approves the Treasury Management Annual Report (section 3);

2.2 Notes the outturn for prudential indicators (section 4); and

2.3 Adopts a new policy on repayment of principal in response to the government issuing new capital finance and accounting regulations (section 5).

3. TREASURY MANAGEMENT ANNUAL REPORT

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. The Executive approves the report and recommends it to Full Council. This section of the report details:-

a) The economic background for 2007/08 (paras 3.3 to 3.4)
b) The agreed treasury strategy (para 3.5)
c) Borrowing activity during 2007/08 (paras 3.6 to 3.9)
d) Lending activity during 2007/08 (paras 3.10 to 3.15)
e) Overall interest paid and received (para 3.16)
f) Developments since the year end (para 3.17)

3.2 Treasury management in this context is defined as ‘the management of the local authority’s cash flows, its banking, money market (mainly short term borrowing and lending) and capital market (long term borrowing) 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.

ECONOMIC BACKGROUND DURING 2007/08

3.3 The economic background has influenced the timing and length of lending / borrowing. World economic growth – 4.9% - remained strong in 2007, driven by recovery in Europe, steady growth elsewhere in the developed economies, rapid growth in developing economies and stellar growth in India and China. The response from central banks was to raise interest rates. However, the problems of sub-prime debt, and the ensuing credit crisis, led to the collapse of two major banks (Northern Rock and Bear Stearns) and falling interest rates in USA and UK. The broader economic problems have been compounded by strong economic growth and rising inflation. The response from central banks has been mixed – USA has reduced rates (from 5.25% to 2%), UK from 5.75% to 5%, but Europe has held rates at 4% and other banks have raised rates. The Bank of England appeared to be surprised by the strength of inflation and is now holding rates while inflation rises.

3.4 As indicated in Table 1, long-term interest rates were volatile. Initially markets anticipated rising short rates – possibly to 6% as inflationary pressures strengthened. The interest rate yield (return) curve has been inverted during 2006 – 2008 (long term rates are usually higher than short term rates to reflect uncertainty about future inflation rates), as pension funds and foreign investors bought gilts at high prices / low yields.

Table 1 – PWLB Interest rates during 2007/08

	31 March 2007 %	30 June %	30 Sept. %	31 March 2008 %
10 year	5.05	5.60	5.20	4.59
25 year	4.65	5.05	4.85	4.63
50 year	4.45	4.80	4.75	4.45

STRATEGY AGREED FOR 2007/08

3.5 On the basis of advice and research, the Treasury Management strategy anticipated that base rate would rise to around 5.5% in 2007/08. It was expected that in-house balances would fall marginally to reflect early borrowing to finance the 2007/08 capital programme. The borrowing strategy assumed that long-term rates would rise during 2007/08. It was therefore agreed to borrow at fixed rates unless short term rates fell sharply, to maintain debt at the authority's Capital Financing Requirement (CFR) and to take advantage of debt restructuring opportunities.[1] Maintaining debt at CFR means that the authority will maintain balances for lending on the money market when they are not required to fund expenditure.

BORROWING ACTIVITY DURING 2007/08

3.6 The split of the council's treasury portfolio between fixed interest and variable loans and investments, as at 31 March 2008, is set out in Table 2.

Table 2 – Treasury portfolio at 31st March 2008 – loans and investments

	31.3.07	31.3.2008	
	Actual £m	Planned £m	Actual £m
Fixed rate loans – PWLB	528.3	536.3	526.8
Variable rate loans – PWLB	-	-	-
Variable rate loans – Market	75.5	75.5	80.5
Short-term loans – Market	-	-	14.2
Total Debt	**603.8**	**611.8**	**621.5**
INVESTMENTS	**90.8**	**97.0**	**110.1**
NET DEBT	**513.0**	**514.8**	**511.4**

3.7 The average rate of interest payable by Brent Council on its loans has fallen from 6.29% in 2005/06, to 5.86% in 2006/07, and to 5.09% in 2007/08. In 2007/08 Brent Council has restructured debt and taken out new loans as follows:

a) Debt restructuring. Two major debt restructurings – one for £12m, the other for £85m were undertaken to take advantage of very low long term rates. Taking into account the premia paid to the PWLB for debt redeemed early, the annual savings generated were around £325k per annum to the General Fund.

b) Borrowing £5m market loan (known as LOBOs – or Lenders Option, Borrowers Option). This loan is fixed at an average rate of 3.98% for an initial period of one year, before the lender may request a change to the rate. If this happens, the Council (the borrower) may repay the loan without penalty rather than pay the increase.

[1] The Capital Financing Requirement 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 advisers, indicates that it is the most economical level for the authority's long-term debt.

c) In addition, £10m has been borrowed from PWLB to finance capital expenditure at an average rate of 4.41%. The 2007/08 capital programme was partly financed in 2006/07, when rates were lower.

Variable rate borrowing was not undertaken because the interest rate curve remained inverted, meaning that longer term borrowing at historically low rates was cheaper and less risky than borrowing short term.

3.8 The PWLB has revised its calculation of the discount rate payable when councils repay debt prematurely. The effect is to raise the size of premia payable (or reduce the value of discounts receivable) to an extent that currently removes opportunity for debt restructuring.

3.9 Length of, and average interest rate on, loans in the treasury portfolio at 31st March 2008 is set out in Table 3.

Table 3 – Treasury portfolio at 31st March 2008 – length/interest rates

Maturing Within	£m 31.03.07	31.03.08	Share of total debt %	Average Interest Rate 2007/08 %
1 Year	9.5	14.2	-	
1 – 2 Years	-	-	-	-
2 – 3 Years	-	-	-	-
3 – 4 Years	-	-	-	
4 – 5 Years	-	-	-	
5 – 6 Years	-	-	-	
6 – 10 Years	-	-	-	-
10 – 15 Years	10.0	5.0	0.8	8.88
Over 15 Years	508.8	521.8	85.9	5.01
Variable – PWLB	-	-	-	
Variable – Market	75.5	80.5	13.3	4.82
TOTAL	**603.8**	**621.5**	**100.0**	**5.09**

LENDING ACTIVITY DURING 2007/08

3.10 The council's investments averaged £118m during 2007/08. The amount invested varies from day to day depending on cash-flow and the Council's borrowing activity. Responsibility for investing these funds is split between the in-house team, which manages approximately 80% of the investments and an external manager which manages approximately 20% of the investments.

3.11 Investments by the in-house team range from overnight deposits of money to up to three years. This results in a lot of activity and a total of £969m was lent out during 2007/08 (2006/07 £942m). Rates achieved ranged between 4.71% and 6.59%, with the average rate being 5.21%. Some of the portfolio had been lent for longer periods over the previous two years to guard against falling interest rates. These were re-deposited as they matured, taking advantage of higher rates which emerged after the credit market difficulties in the summer. Funds held to manage shorter term cash flow needs have been deposited substantially in Money Market Funds, taking advantage of similarly high inter-bank rates. Economic research and advice from the council's treasury advisers, Butler's, indicated that rates would rise steadily rather than sharply. Loans were made to high quality counterparties included on the Treasury Lending list.

3.12 External cash managers were initially appointed in 1998 to manage two portfolios with the aim of achieving an improved return at an acceptable level of risk. Aberdeen Asset Management has managed throughout the period, Alliance Capital Management was appointed in December 2004 and was terminated in August 2007 following their giving notice of exiting the local authority cash fund market. The value of the Aberdeen's portfolio was £21.3m as at 31st March 2008. Actual performance for 2007/08 (2006/07 in brackets), and the three and five years to 2007/08 is set out in Table 4.

Table 4 - Performance of Aberdeen Asset Management against benchmark

	Aberdeen %		Brent in-house %	7 Day LIBID Benchmark %
2007/08	5.7 (4.65)		5.2 (4.83)	5.7 (4.80)
Three Years	5.0		4.9	5.1
Five Years	4.7		4.7	4.7

3.13 Aberdeen matched the benchmark in 2007/08, a good performance in a market which first rose and then fell. The manager used shorter dated certificates of deposit (CDs) initially, underperforming in quarters when rates were rising. However, the manager switched to longer dated CDs when rates reached the top of the interest rate cycle, and recovered lost ground.

3.14 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 (pooled funds managed by city finance houses) or by lending on the 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, some loans made in 2006/07, when rates were expected to stay low, yielded less than market rates in 2007/08 as rates continued to rise. This has been offset to an extent by some more recent deposits arranged at more attractive rates.

3.15 The three and five year records indicate that Aberdeen has not achieved their out-performance target (+0.5% per annum). However, Aberdeen is among the best managers over all periods, which have seen low and falling gilt yields.

OVERALL INTEREST PAID AND RECEIVED

3.16 Overall interest paid and received in 2007/08 is shown in Table 5. The additional interest paid on external debt reflects early borrowing (at a lower rate) to fund the capital programme. The increased interest received on deposits reflects higher market rates (5.2% received against 4.5% assumed) and higher cash balances (average £118m).

Table 5 – Overall interest paid and received in 2007/08

	Budget £m	**Actual £m**
Interest paid on external debt	30.5	31.2
Interest received on deposits	3.0	6.2
Debt management expenses	0.4	0.2

DEVELOPMENTS SINCE THE END OF THE YEAR

3.17 The market anticipates that short-term interest rates may rise as a result of inflation concerns. As the Consumer Price Index has risen to 3.8%, the Governor of the Bank of England has written to the Chancellor of the Exchequer explaining what is being done to reduce inflation to the 2% target. Long term rates have also risen. Following changes in Public Works Loans Board discount rate calculations, there are currently no debt restructuring opportunities.

4. PRUDENTIAL INDICATORS – 2007/08 OUTTURN

4.1 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 approvals to borrow money (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.

4.2 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 2007/08 was agreed by Full Council in March 2007, and has not required amendment.

4.3 The outturn for prudential indicators measuring affordability is set out in Table 6 below. General Fund capital financing charges as a proportion of total budget were lower than in the original estimates principally because of lower cost of borrowing and higher interest on investments. The increase in capital financing charges as a proportion of spend on the HRA was a result of change of treatment in the calculation of premia charged to the HRA following debt restructurings. These were not included in the estimate but are included in the actual. There was no real impact on the HRA from this change.

Table 6 – Prudential indicators measuring affordability

	2007/08 (estimates)	2007/08 (actual)
Capital financing charges as a proportion of net revenue stream:		
- General Fund	7.82%	6.76%
- HRA	29.54%	33.86%
Impact of unsupported borrowing on:		
- Council tax at Band D	£32.31	£25.17
- Weekly rent	-	-

4.4 The outturn for prudential Indicators for capital spending is set out in Table 7 below. Movements within the capital programme, including slippage between years and resources becoming available during the year, were reported in the Performance and Finance Outturn report to the Executive in July 2008. Capital spending is funded from a variety of resources, including government grants, capital receipts, revenue contributions, Section 106 contributions and borrowing. This means that movements in capital spending are not directly reflected in movements in the Capital Financing Requirement, which principally reflects borrowing requirements. Borrowing in 2007/08 was less than estimated which meant a lower overall Capital Financing Requirement.

Table 7 – Prudential indicators measuring capital spending and CFR

	2007/08 Estimates £m	2007/08 Actual £m
Planned capital spending:		
- General Fund	60.3	72.9
- HRA	18.4	11.0
- Total	78.7	83.9
Estimated capital financing requirement for[2]:		
- General Fund	264.9	254.0
- HRA	338.3	325.2
- Total	603.2	579.2

[2] The Capital Financing Requirement estimates in this table are at 31st March of each year.

4.5 The Council also sets prudential indicators for external debt which are shown in Table 8. This is to ensure that the council's overall borrowing is kept within prudent limits. 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. In 2007/08 the council undertook a major programme of debt restructuring as set out in paragraph 3.7. Waiting for the best deal meant that external debt exceeded the Operational Boundary for a week. 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.

Table 8 – Prudential indicators for external debt

Indicator	Limit	Status
Authorised limit for external debt	£780m	Met
Operational boundary for external debt	£680m	Largely Met (see para.4.5)
Net borrowing	Below CFR	Met

4.6 The prudential indicators for treasury management, which are included in Table 9 below, were all met. These are 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 all re-financing happening 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 also ensures that a minimum level of balances is available for cash flow purposes. Although interest rates were rising during 2007/08, opportunities for long-term lending have been taken when the market has appeared to be too pessimistic about rising rates. Overall, investments of more than one year did not change during the year, with a total of £20m at the beginning and end of the year.

Table 9 – Prudential indicators for treasury management

Indicator	Limit	Actions
Treasury Management Code		Adopted in 2002
Exposure to interest rate changes		
- fixed rate upper limit	100%	100%
- variable rate upper limit	40%	7%
Maturity of fixed interest loans		
Under 12 months		
- upper limit	40%	2%
- lower limit	0%	0%
12 months – 24 months		

- upper limit - lower limit	20% 0%	0% 0%
24 months – 5 years - upper limit - lower limit 5 years – 10 years - upper limit - lower limit Above 10 years - upper limit - lower limit	 20% 0% 60% 0% 100% 30%	 0% 0% 1% 0% 100% 97%
Upper limit on investments of more than one year	**£60m**	**£50m**

5. MINIMUM REVENUE PROVISION

5.1 The Local Authorities (Capital Finance and Accounting) Regulations 2003 set out the requirement that councils set aside a minimum of 4% of their General Fund capital financing requirement to repay principal on debt, regardless of the length of life of the asset that was being financed.

5.2 Revised regulations which amend this requirement were issued earlier in 2008.[3] Under the new regulations councils are required to set an amount of Minimum Revenue Provision which is 'prudent'. The definition of what counts as 'prudent' is set out in statutory guidance which has been issued by the Secretary of Sate for Communities and Local Government and which authorities are required to 'have regard' to.

5.3 Under the guidance councils are required to prepare an annual statement of their policy on making Minimum Revenue Provision to Full Council. The purpose of this is to give Members the opportunity to scrutinise use of the additional freedoms and flexibilities under the new arrangements.

5.4 The guidance distinguishes between borrowing which is supported by the government through the Revenue Support Grant system and other borrowing where councils use their prudential borrowing powers to borrow above the supported borrowing level.

5.5 For borrowing which is supported by the government through the Revenue Support Grant system, authorities are allowed to continue to apply the 4% Minimum Revenue Provision based on the level of borrowing.[4] The guidance provides councils two options for carrying out this calculation. Option 1, 'the regulatory method', is to continue to use the calculations that were used under the system that existed from 2004/05 when the previous regulations came into effect. This means that the amount of non-housing Capital Financing Requirement, adjusted as set out in the original regulations (Adjustment A'), is used as the starting position for the MRP calculation in 2008/09 and adjusted

[3] Local Authorities (Capital Finance and Accounting) (Amendment) Regulations 2008 – SI 2008/404

[4] Members will note that in practice, as a grant floor authority, Brent does not receive the benefit of this supported borrowing. Nevertheless a figure for supported borrowing is provided each year to the council and it is this figure which will be used in the calculation of the 4% Minimum Revenue Provision.

thereafter for supported borrowing in each year. Option 2, the CFR method, is similar to Option 1 but does not include any adjustments to the CFR.

5.6 For new borrowing under the Prudential system, councils are required to adopt from 2008/09 one of two further options for determining a prudent amount of Minimum Revenue Provision.[5] Option 3, which is 'the asset life method', allows councils to make provision for repayment of principal over the estimated life of the asset. This can be done using the 'equal instalment' method, where equal amounts of principal are paid each year, with reducing interest payments as debt is repaid, or the 'annuity' method, which is akin to a mortgage where the combined sum of principal and interest are equalised over the life of the asset. Option 4, which is the 'depreciation method', involves making Minimum Revenue Provision in accordance with the standard rules of depreciation accounting. This means setting aside an amount each year in line with estimated annual depreciation until the total initial debt is provided for.

5.7 The policy proposed for 2008/09 for non-HRA assets is as follows:

- For supported borrowing, it is proposed that the council continues with the existing method (Option 1). This is in line with assumptions made within the 2008/09 budget and the council's medium term financial strategy. It also ties in with the basis on which grant is calculated, albeit that so long as the council is on the grant floor, it does not receive the benefit of the additional grant funding. Option 1leads to a lower level of Minimum Revenue Provision than Option 2, and avoids the council having to make complex calculations for all its assets which it would have to do if Options 3 or 4 were adopted for supported borrowing.

- For prudential borrowing, it is proposed that the council adopts Option 3, 'the asset life method', and that an 'annuity' approach is used for calculating repayments. This ensures payments are spread equally over the life of the asset, which matches more closely the value the council gets out of the asset than loading payments at the beginning as would happen under the equal instalment method. It is also considerably easier to understand and more transparent than the depreciation method (Option 4). The proposed asset lives which will be applied to different classes of assets are as follows:

    - Vehicles and equipment – 5 to 15 years;
    - Capital repairs to roads and buildings – 15 to 25 years;
    - Purchase of buildings – 30 to 40 years;
    - New construction[6] – 40 to 60 years;
    - Purchase of land – 50 years (unless there is a structure on the land with an asset life of more than 50 years, in which case the land would have the same asset life as the structure).

[5] The amendment regulations apply to the 2007/08 financial year as well as subsequent years. However, the statutory guidance does allow authorities to apply Option 1 or 2 to prudential borrowing carried out in 2007/08. In practice, the option adopted in the council's 2007/08 accounts for prudential borrowing was Option 1.

[6] Purchase of buildings, new construction and purchase of land includes spending related to the provision of additional residential units for rent outside the HRA using prudential borrowing powers.

The guidance also sets out the approach to be taken to specific expenditure types which do not fall within these general categories, including spending capitalised under directions issued by the Secretary of State, capital grants to other organisations and individuals and so on. Details of the maximum asset life that can be applied in these cases are attached as Appendix A. The guidance also requires that the life of the asset is determined in the year in which it is acquired and is not varied subsequently.

5.8 The council is also required to set out a policy retrospectively for 2007/08. The guidance permits the use of Options 1 and 2 for both supported and prudential borrowing in 2007/08. In practice, the council's accounts have already been closed for 2007/08 using the existing method set out in Option 1 for both supported and prudential borrowing.

5.9 These policies do not apply to HRA assets. The duty to make Minimum Revenue Provision in the Local Authorities (Capital Finance and Accounting) Regulations 2003 does not apply to HRA assets.

5.10 Should there be any amendments to the policies set out in this section of the report, these will be reported to Full Council at that time.

6. FINANCIAL IMPLICATIONS

6.1 As set out in the report, the council made savings on external interest paid in 2007/08 mainly as a result of 0

8. DIVERSITY IMPLICATIONS

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

9. LEGAL IMPLICATIONS

9.1 Guidance has been issued under s21(1A) of the Local Government Act 2003 ("the 2003 Act") on how to determine the level of prudent provision. Authorities are required by section 21(!B) to have regard to this guidance.

9.2. Under regulation 28 of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 (as amended) authorities have significant discretion in determining their Minimum Revenue Provision but, as a safeguard, the guidance issued under the 2003 Act recommends the formulation of a plan or strategy annually for the determination of the Minimum Revenue Provision which should be considered by the whole Council. This mirrors the existing requirement to report to Council on the prudential borrowing limit and investment policy. The Local Authorities (Functions and Responsibilities) (England) (Amendment) Regulations 2000 have been amended to reflect that the formulation of such a plan or strategy should not be the sole responsibility of the Executive.

10. BACKGROUND INFORMATION

1. Loans Register.
2. Logotech Loans Management System.
3. Butler quarterly and special reports on treasury management.
4. Aberdeen Asset Management quarterly reports.
5. 2007/08 Budget and Council Tax report – 5th March 2007

11. CONTACT OFFICERS

1. Martin Spriggs, Head of Exchequer and Investments – 020 8937 1472
2. Paul May, Capital Accountant – 020 8937 1568

DUNCAN McLEOD
Director of Finance and
Corporate Resources

Appendix A

Statutory guidance on the approach to be taken to assessing asset life of specific expenditure types

Expenditure Type	Maximum Value of Asset Life
Expenditure capitalised by virtue of a direction by the Secretary or State	20 years
Expenditure on computer programs	The life of computer hardware
Loans and grants towards capital expenditure by third parties	The estimated life of the assets in relation to which the third party expenditure is incurred
Repayment of grants and loans for capital expenditure	25 years, or the period of the loan if longer
Acquisition of share or loan capital	20 years
Expenditure on works to assets not owned by the authority	The estimated life of the assets
Expenditure on assets for use by others	The estimated life of the assets
Payment of levy on Large Scale Voluntary Transfers (LSVTs) of dwellings	25 years