LONDON BOROUGH OF BRENT

EXECUTIVE – 24th MAY 2004

REPORT FROM THE DIRECTOR OF FINANCE

For Decision

Wards Affected
None Specifically

FP REF: BFS-03/04-77

TREASURY MANAGEMENT: ANNUAL INVESTMENT STRATEGY 2004/05

1 SUMMARY

The report details the proposed Annual Investment Strategy for 2004/05.

2 RECOMMENDATIONS

Members are asked to recommend the Annual Investment Strategy for 2004/05 to Full Council for consideration.

3 FINANCIAL IMPLICATIONS

These are contained within the body of the report.

4. LEGAL IMPLICATIONS

4.1 Under section 12 of the Local Government Act 2003 the Council has power to invest for any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs.

4.2 The Council is required to have due regard to the guidance on Local Government Investments which was issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003.

4.3 This guidance recommends that the Council produce an Annual Investment Strategy and that it would be preferable for the Strategy to be approved by Full Council (rather than the Executive).The latter recommendation has now been implemented in legislation. The Local Authorities (Functions and Responsibilities) (England) Regulations 2000 are amended from 19 May 2004 to make it a requirement that the investment strategy be adopted by Full Council.

4.4 The effect of the amendment to the Functions and Responsibilities (England) Regulations 2000 is that in future years the investment strategy will be adopted by Full Council as part of the budget setting process. In order to give effect to this, officers are recommending to Full Council on 17 May 2004 that the definition of the budget be amended to include reference to decisions relating to investment. Once the investment strategy is in place, it will be the role of the Executive to implement it.

5 STAFFING IMPLICATIONS

None.

6 EQUALITY AND DIVERSITY

There are no diversity implications arising from the report.

7 DETAIL

Background

7.1 Treasury management activity in local authorities has previously been based on four major regulatory planks:

a) Local authorities do not have power to borrow to invest.

b) Prohibition of the use of derivatives by local authorities, as set out in the House of Lords decision in Hazel v Hammersmith and Fulham and Others (1991).

c) The Local Authorities (Capital Finance) (Approved Investments) Regulations 1990, which set out those instruments that may be used by authorities without the investment being classed as capital expenditure. The approved instruments were gilts, certificates of deposit, term deposits, treasury bills and bills of exchange. Recently money market funds and the Debt Management Office Deposit facility were added to the list.

d) The CIPFA Treasury Management Code, adopted by Brent Council in 2002. The Code established that the Director of Finance must present an Annual Investment Strategy and an Annual Report to Full Council.

7.2 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) The Guidance is not applicable to investment in pension funds.

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

d) Authorities should prepare an Annual Investment Strategy (AIS), to be agreed by Full Council before the commencement of each year. Unfortunately the Guidance was not published until March 2004, so that the AIS is being presented at the earliest opportunity.

e) 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).

f) 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

7.3 Brent Council had £57m in cash balances as at 31st March 2004. This was reduced from 1st April 2003 (£64m) following two major debt restructuring exercises that have saved approximately £1.4m in 2003/4 (and further amounts in future years). The balances are diversified into three portfolios – two external managers (Morley Fund Management £23.5m and Aberdeen Asset Management £11m) and the in-house manager (£22.5m). The in-house manager makes deposits with banks, building societies, local authorities and other reputable borrowers, whereas the external managers can invest in gilts and certificates of deposit as well as ordinary deposits. The lending list of authorised borrowers – drawn up by the Director of Finance and used by all three managers – uses credit ratings (long term, short term, individual and support) to place limits on loans to individual institutions.

7.4 The proposed AIS for 2004/5 is attached as Appendices 1 and 2, using a template produced by Brent's treasury adviser, Sector. Investments are categorised as either Specified or Non-specified Investments.

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 to banks, building societies etc) are NOT involved, external fund managers will take investment decisions within their Investment Management Agreements.

8 BACKGROUND INFORMATION

Office of the Deputy Prime Minister – Local Government Investments – Guidance under Section 15(1)(a) of the Local Government Act 2003.

Sector – Annual Investment Strategy template.

Executive – Treasury Management Annual Report 2002/03 – September 2003.

Executive – Annual Treasury Strategy – February 2004.

Any person wishing to inspect the above papers should contact the Exchequer and Investment Team, Room 115, Brent Town Hall (telephone 0208 937 1472/1474).

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Director of Finance

MARTIN SPRIGGS
Head of Exchequer & Investment

ANNUAL INVESTMENT STRATEGY 2004-05

1. Brent Council has regard to the Office of the Deputy Prime Minister's Guidance on Local Government Investments ("Guidance") and CIPFA's Treasury Management in the Public Services.

2. Investment Principles

2.1 All investments will be in sterling. The general policy objective is the prudent investment of its treasury balances. The Council will aim to achieve the **optimum return** on its investments commensurate with the proper levels of security and liquidity.

2.3 The Guidance maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

3. Specified and Non-Specified Investments

3.1 Investment instruments identified for use in the financial year are listed in Appendix 2 under the 'Specified' and 'Non-Specified' Investments categories.

3.2 The Appendix also sets out:

(a) the advantages and associated risk of investments under the category of "non-specified" category;

(b) the upper limit to be invested in each 'non-specified' asset category;

(c) which instruments would best be used by the Council's external fund managers or after consultation with the Council's treasury advisors.

4. Liquidity

4.1 Based on its cash flow forecasts, the Council anticipates its fund balances in 2004-05 to range between £50m and £70m.

4.2 Giving due consideration to the Council's level of balances over the next three years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has determined that up to £40m may be held in 'non specified' investments during the year.

4.3 Appendix 2 sets out the maximum periods for which funds may be prudently committed in each asset category.

5. Security of Capital: The Use of Credit Ratings

5.1 Credit quality of counterparties (issuers and issues) and investment schemes will, in the first instance, be determined by reference to credit ratings published by Fitch IBCA, Standard and Poors and Moodies *(*long-term,/short-term, individual and support). The external managers will use Brent Council's Lending List to establish authorised borrowers.

5.2 Monitoring of credit ratings:

- All credit ratings will be monitored on an on-going basis. Brent Council is alerted to changes in Fitch ratings through its use of the Sector website and emails.
- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- If a counterparty/investment scheme is upgraded so that it fulfils the Council's criteria, the Head of Exchequer & Investment will have discretion to include it on the lending list.

6. Investments Defined as Capital Expenditure

6.1 The acquisition of share capital or loan capital in any body corporate is defined as capital expenditure. Brent Council will not use or allow its external fund managers to make any investment which will be deemed capital expenditure.

7. Provisions for Credit-Related Losses

If any of the Brent Council's investments appeared at risk of loss due to default, the Council will make revenue provision of an appropriate amount.

8. Investment Strategy to be Followed In-House

8.1 Investments will be made with reference to the core balance (£60m) and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

8.2 Brent Council will seek to utilise its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the compounding of interest at potentially higher rates, while looking for longer-term opportunities when the market becomes too pessimistic about rising rates. Brent Council has identified 5% as an attractive trigger rate for 1-year lending, 5.5% for 2 year, and 6% for *3* year lending. The 'trigger points' will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

9. External Cash Fund Management

9.1 Brent Council's funds are managed on a discretionary basis by Aberdeen Asset Management and Morley Fund Management. The fund managers will be contractually required to comply with this Strategy.

9.2 Brent Council will discuss with its external fund managers on a regular basis, instruments that they consider may be prudently used to meet the Council's investment objectives. Brent Council will evaluate the risk-reward characteristics of asset categories to decide whether to permit the managers to use instruments that comply with the Guidance.

APPENDIX 2

LOCAL GOVERNMENT INVESTMENTS

SPECIFIED INVESTMENTS

All "Specified Investments" listed below must be sterling-denominated.

Investment	Share/ Loan Capital?	Repayable/ Redeemable Within 12 Months?	Security/ Minimum Credit Rating **	Capital Expenditure?	Circumstance of Use	Maximum Period
Debt Managemen t Agency Deposit Facility	No	Yes	Govt-backed	NO	In-house	1 year
Term or callable deposits with the UK government or with UK local authorities	No	Yes	High security although Las not credit rated.	NO	In-house and by external fund managers	1 year
Term or callable deposits with credit-rated deposit takers (banks and building societies)	No	Yes	Yes-varied	NO	In-house and by external fund managers	1 year
Certificates of Deposit issued by credit-rated deposit takers (banks and building societies)	No	Yes	Yes-varied	NO	to be used by fund managers	1 year
Gilts : with maturities up to 1 year	No	Yes	Govt-backed	NO	external cash fund managers subject to the management agreement	1 year
Money Market Funds (i.e. a highly rated collective investment scheme)	No	Yes	Yes- *minimum : AAA*	NO	In-house and by external fund managers subject to the management agreement	*Subject to cash flow and liquidity requiremen ts*

Investment	Share/ Loan Capital?	Repayable/ Redeemable Within 12 Months?	Security/ Minimum Credit Rating **	Capital Expenditure?	Circumstance of Use	Maximum Period
Forward deals with credit rated banks and building societies	No	Yes	Yes- varied	NO	In-house and fund managers	1 year in aggregate
Commercial paper *[short-term obligations (generally with a maximum life of 9 months issued by banks and other issuers]*	No	Yes	Yes- varied	NO	external fund managers subject to the management agreement	9 months
Treasury bills [*Government debt security with a maturity less than one year and issued through a competitive bidding process at a discount to par value*]	No	Yes	Govt- backed	NO	external fund managers subject to the management agreement	1 year
Bonds issued by a financial institution that is guaranteed by the United Kingdom Government	No	Yes	Govt- backed	No	trading by external cash fund managers only subject to management agreements	1 year
Bonds issued by multilateral development banks	No	Yes	AAA	No	trading : by external cash fund managers subject to management agreements	1 year

NON-SPECIFIED INVESTMENTS

Investment	(A) Why Use It? (B) Associated Risks?	Share/ Loan Capital?	Repayable/ Redeemable Within 12 Months?	Security/ Minimum Credit Rating **	Capital Expenditure?	Circumstance of Use	Max % of Overall Investments	Maximum Maturity of Investment
Term deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A)(i) Certainty of rate of return over period invested. (ii) No movement in capital value of deposit despite changes in interest rate environment. (B)(i) Liquid : as a general rule, cannot be traded or repaid prior to maturity. (ii) Return will be lower if interest rates rise after making the investment. (iii) Credit risk : potential for greater deterioration in credit quality over longer period	No	No	YES-varied	NO	in-house	100%	*3 years*
Certificates of Deposit with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A)(i) Although in theory tradable, are relatively illiquid. (B)(i) 'Market or interest rate risk' : Yield subject to movement during life of CD which could negatively impact on price of the CD.	No	Yes	YES-varied	NO	to be used by fund managers	80%	*3 years*
UK government gilts with maturities in excess of 1 year	(A)(i) Excellent credit quality. (ii) Very Liquid. (iii) If held to maturity, known yield (rate of return) per annum ~ aids forward planning. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (v) No currency risk (B)(i) 'Market or interest rate risk' : Yield subject to movement during life of sovereign bond which could negatively impact on price of the bond i.e. potential for capital loss.	No	Yes	Govt backed	NO	external cash fund managers only subject to the management agreement	50%	*10 years*

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Investment	(A) Why Use It? (B) Associated Risks?	Share/ Loan Capital?	Repayable/ Redeemable Within 12 Months?	Security/ Minimum Credit Rating **	Capital Expenditure?	Circumstance of Use	Max % of Overall Investments	Maximum Maturity of Investment
Sovereign issues ex UK govt gilts : any maturity	(A)(i) Excellent credit quality. (ii) Liquid. (iii) If held to maturity, known yield (rate of return) per annum ~ aids forward planning. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (v) No currency risk (B)(i) 'Market or interest rate risk' : Yield subject to movement during life of sovereign bond which could negatively impact on price of the bond i.e. potential for capital loss.	No	Yes	AAA	NO	external cash fund managers subject to the management agreement	50%	*10 years*
Forward deposits with credit rated banks and building societies for periods > 1 year (i.e. negotiated deal period plus period of deposit)	(A)(i) Known rate of return over period the monies are invested ~ aids forward planning. (B)(i) Credit risk is over the whole period, not just when monies are actually invested. (ii) Cannot renege on making the investment if credit rating falls or interest rates rise in the interim period.	No	No	YES-varied	NO	To be used in-house	50%	*3 years*
Bonds issued by a financial institution that is guaranteed by the United Kingdom Government	(A)(i) Excellent credit quality. (ii) Relatively liquid. (although not as liquid as gilts) (iii) If held to maturity, known yield (rate of return) per annum, which would be higher than that on comparable gilt ~ aids forward planning, enhanced return compared to gilts. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (B)(i) 'Market or interest rate risk' : Yield subject to movement during life of bond which could negatively impact on price of the bond i.e. potential for capital loss. (ii) Spread versus gilts could widen.	Yes	Yes	AAA / government guaranteed	NO	external cash fund managers only, subject to the management agreement	80%	*3 years*

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Investment	**(A) Why Use It?** **(B) Associated Risks?**	**Share/ Loan Capital?**	**Repayable/ Redeemable Within 12 Months?**	**Security/ Minimum Credit Rating ****	**Capital Expenditure?**	**Circumstance of Use**	**Max % of Overall Investments**	**Maximum Maturity of Investment**
Bonds issued by multilateral development banks	(A)(i) Excellent credit quality. (ii) Relatively liquid. (although not as liquid as gilts) (iii) If held to maturity, known yield (rate of return) per annum, which would be higher than that on comparable gilt ~ aids forward planning, enhanced return compared to gilts. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity). (B)(i) 'Market or interest rate risk' : Yield subject to movement during life of bond which could negatively impact on price of the bond i.e. potential for capital loss. (ii) Spread versus gilts could widen.	Yes	Yes	AAA or government guaranteed	NO	external cash fund managers only, subject to the management agreement	80%	*3 years*

* **The prohibition on the use of derivatives** : This prohibition effectively relies on the judgement of the House of Lords in the case of Hazell v The Council of the London Borough of Hammersmith and Fulham and Others in 1991. Their Lordships held that local authorities have no power to enter into interest rate swaps and similar instruments.

Sector believes that as this ruling still stands and will not be rescinded by the introduction of the Local Government Act 2003, local authorities will not have the power to use derivative instruments.