ITEM NO: 11

BRENT COUNCIL

Executive
17th July 2006

Report from the Director of Finance and Corporate Resources

For Action

Wards Affected: ALL

The Treasury Management Annual Report 2005/06

Forward Plan reference BFS/3

1 SUMMARY

The report details Treasury Management activity and performance during 2005/06.

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. The Executive approves the report and recommends it to Full Council. This report details:-
a) the economic background for 2005/06 (paras 3.5 to 3.6)
b) the agreed treasury strategy (para. 3.7)
c) prudential code activities for 2005/06 (paras 3.8 to 3.11)
d) treasury management activities during 2005/06 (paras 3.12 to 3.16)
e) the performance of the external cash managers during 2005/06 (paras 3.17 to 3.20)

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.

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 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.

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 2005/06 was agreed by Full Council in March 2005, and has not required amendment.

ECONOMIC BACKGROUND DURING 2005/06

3.5 The economic background has influenced the timing and length of lending / borrowing. World economic growth - 4.6% - was strong in 2005, driven by continued recovery in Japan and stellar growth in India and China. While GDP in USA grew by 3.5%, UK (1.8%) and Europe (1.4%) were more sedate. As growth continued, policy makers were concerned about rising inflation as low interest rates led to overheating in consumer demand / debt, and to more sharp rises in oil and commodity prices. The response has been rising short term interest rates – USA from 2.25% to 4.25% (now 5%), Europe from 2% to 2.25% (now 2.75%) – and Japan has ended its policy of 'quantitative easing' to ensure that businesses have access to credit that has flooded world markets with liquidity. UK reduced rates in 2005 (only once - from 4.75% to 4.5%).

3.6 As indicated in Table 1, long-term interest rates fell and rose during the year. Initially markets anticipated falling short rates – towards 4% / 4.25% as the economy slowed. The interest rate yield (return) curve was flat for most of 2005 (long term rates are usually higher than short term rates to reflect uncertainty about future inflation rates), but inverted (long rates below short rates) towards the end of the year as overseas governments, hedge funds and pension funds invested in new 50 year UK government gilts, with real yields falling to less than 0.5%. However, rates have subsequently risen, though they remain inverted and at very low levels. The Public Works Loans Board (PWLB), a government agency that lends to local authorities at preferential rates linked to government bond yields, introduced new maturities up to 50 years starting on 7th December at 4.2%. The rate subsequently fell to 3.7%, before rising to 4.15% on 31st March. The table below shows ten, twenty-five and fifty year PWLB rates during the year.

Table 1 – PWLB Interest rates during 2005/06

	31 March 2005 %	30 June %	30 Sept. %	31 March 2006 %
10 year	4.85	4.4	4.45	4.55
25 year	4.8	4.4	4.4	4.35
50 year	-	-	-	4.15

STRATEGY AGREED FOR 2005/06

3.7 On the basis of advice from economists, fundmanagers and in-house research, the Treasury Management strategy anticipated that base rate would remain around 4.75% in 2005/06. It was expected that in-house balances would remain steady, 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 remain stable during 2005/06 (at around 5%). 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.) Maintaining debt at CFR means that the authority will maintain balances that are available for lending on the money market when they are not required to fund expenditure .

OUTTURN 2005/06 - 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 2005/06 which is also on this agenda. The CFR for 2005/06 was expected to be £552.5m, the actual was £549.6m. The Prudential Indicators for external debt were as follows:-

Indicator	Limit	Status
Authorised limit for external debt	£700m	Met
Operational boundary for external debt	£600m	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%	100%
- variable rate upper limit	40%	16%
Maturity of fixed interest loans		
Under 12 months		
- upper limit	40%	10%
- lower limit	0%	0%
12 months – 24 months		
- upper limit	20%	3%
- lower limit	0%	0%
24 months – 5 years		
- upper limit	20%	5%
- lower limit	0%	3%
5 years – 10 years		
- upper limit	60%	17%
- lower limit	0%	15%
Above 10 years		
- upper limit	90%	78%
- lower limit	30%	70%
Upper limit on investments of more than one year	**£50m**	**£15m**

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 fairly stable during 2005/06, there have been occasional opportunities for long-term lending, as shown in the table above, when the market has been too pessimistic about rising rates. The increase in investments of more than one year to £15m, which includes deals agreed but not yet implemented, occurred gradually over the second half of the year.

OUTTURN 2005/06 – TREASURY MANAGEMENT

3.12 The Council's treasury portfolio as at 31 March 2006 was as follows:-

	31.3.05 Actual £m	**31.3.2006 Planned £m**	**31.3.2006 Actual £m**
Fixed rate loans – PWLB	411.3	467	501.3
Variable rate loans – PWLB	20.0	20	-
Variable rate loans – Market	65.5	65.5	70.5
Short-term loans - Market	-	-	-
Total Debt	**496.8**	**552.5**	**571.8**
INVESTMENTS	**66.9**	**86**	**100.0**
NET DEBT	**429.9**	**466.5**	**471.8**

3.13 The value of investments rose as the authority took advantage of low rates to fund the 2006/07 capital programme during 2005/06. The average rate of interest payable by Brent Council fell from 6.47% in 2004/05 to 6.29% in 2005/06. In 2005/06 Brent Council has taken out new loans as follows:

a) Borrowing £10m market loans (known as LOBOs – or Lenders Option, Borrowers Option). This loan is fixed at an average rate of 4.39% for an initial period of three years, before falling to 4.1% for five years, following which the lender may request a change to the rate. If this happens, the borrower may repay the loan without penalty rather than pay the increase.

b) In addition, £100m has been borrowed from PWLB at an average rate of 4.2%. This was partly to finance maturities totalling £30m (average rate 4.77%), and partly to finance capital expenditure. Early in January 2006 the opportunity was taken to finance the 2006/07 capital programme in advance, when exceptionally low long-term rates were available - £30m was borrowed at an average rate of 3.93% for a period of 50 years.

Variable rate borrowing was not undertaken because long-term fixed rates fell sharply as the interest rate curve inverted.

3.14 As at 31st March 2006, the debt portfolio was as follows:

Maturing Within	£m 31.03.05	£m 31.03.06	2006 %	Average Interest Rate 2005/06 %
1 Year	10.0	-	-	
1 – 2 Years	-	9.5	1.7	9.04
2 – 3 Years	9.5	15.0	2.6	8.00
3 – 4 Years	15.0	-	-	
4 – 5 Years	-	-	-	
5 – 6 Years	-	-	-	
6 – 10 Years	77.0	87.0	15.2	9.45
10 – 15 Years	12.5	15.0	2.6	5.87
Over 15 Years	287.3	374.8	65.6	5.53
Variable - PWLB	20.0	-	-	
Variable – Market	65.5	70.5	12.3	4.82
TOTAL	**496.8**	**571.8**		

3.15 The in-house team has lent a total of £942m (2004/05 £263m) at rates between 4.27% and 5.82%, and at an average rate of 4.77%. The total available to lend rose during the year, especially after the early borrowing to fund the 2006/07 capital programme. The lending strategy followed was to lend money for short periods, but to 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. At the beginning of the year, short term rates were unexpectedly low, but they rose to be in line with base rate after the August rate cut. Loans were made to high quality counterparties included on the Treasury Lending list.

3.16 Other budgetary details for 2005/06 were as follows:

	Budget £m	Actual £m
Interest paid on external debt	36.4	34.7
Interest received on deposits	3.3	4.4
Debt management expenses	0.4	0.2

The reduction on interest paid on external debt reflects savings through restructurings carried out in previous years and the impact of the decision to borrow early to fund the 2006/07 capital programme. Borrowing early added to balances – as the capital payments will not occur until 2006/07 – thereby increasing interest received on deposits. The reduced cost of debt management expenses reflects the lack of debt restructuring opportunities during 2005/06.

EXTERNAL CASH MANAGERS

3.17 External cash managers were 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, but Alliance Capital Management was appointed in December 2004. The value of the Alliance's portfolio was £19.5m as at 31st March 2006, whereas Aberdeen's was £18.7m. Actual performance for 2005/06 (2004/05 in brackets), and the three and five years to 2005/06 has been as follows: -

	Aberdeen %	Alliance %	Brent in-house %	7 Day LIBID Benchmark %
2005/06	4.79 (4.69)	4.8 (-)	4.77 (4.58)	4.67 (4.58)
Three Years	4.4	-	4.4	4.3
Five Years	4.6	-	4.5	4.3

3.18 Aberdeen marginally outperformed the benchmark in 2005/06. The manager used certificates of deposit in the year, locking into the market anticipating rising short term rates, but not being able to lock into longer term gilt yields, which did not rise. Alliance has marginally outperformed a somewhat different benchmark (a combination of gilts and cash – 4.66% for 2005/06) since appointment. The year was very difficult – rates varied little, and there were 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.

3.19 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.

3.20 The three and five year records indicate that Aberdeen has outperformed during the period, but not achieved their outperformance target (+0.5% per annum). 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

3.21 The market anticipates that short-term interest rates may rise marginally during the remainder of 2006/07. However, the managers feel that rates will remain at 4.75% for some time. Longer rates have risen marginally, but are currently volatile as equity markets fall. Following a £36m restructuring (loans averaging 4.73% repaid, new loan at 4.25% borrowed), It is anticipated that there may be further opportunities for debt restructuring in 2006/07 if long-term rates rise.

4 FINANCIAL IMPLICATIONS

As set out in the report, the Council made savings on external interest paid in 2005/06 mainly as a result of restructuring of debt in earlier years offset by borrowing in advance for 2006/07. Interest on cash balances also rose during the year (up from £3.3m in 2004/05 to £4.4m) as balances increased.

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.

Alliance Capital Fund Management and Aberdeen Asset Management quarterly reports.

Reports to the Executive – Treasury Management Annual Report 2004/05 – 11th July 2005; 2005/06 Budget Reports on Treasury Strategy and Prudential Code, and Annual Investment Strategy – February 2005

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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