ITEM NO: 10

BRENT COUNCIL	**Executive** 16th July 2007 **Report from the Director of Finance and Corporate Resources**
	Wards Affected: NONE
The Treasury Management Annual Report 2006/07	

Forward Plan Ref: F&CR 06/07-46

1 SUMMARY

The report details Treasury Management activity and performance during 2006/07.

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 2006/07 (paras 3.5 to 3.6)

b) the agreed treasury strategy (para. 3.7)

c) Prudential Code activities for 2006/07 (paras 3.8 to 3.11)

d) treasury management activities during 2006/07 (paras 3.12 to 3.16)

e) the performance of the external cash managers during 2006/07 (paras 3.17 to 3.20) and proposals to revise the current arrangements.

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 2006/07 was agreed by Full Council in March 2006, and has not required amendment.

ECONOMIC BACKGROUND DURING 2006/07

3.5 The economic background has influenced the timing and length of borrowing and lending. World economic growth – 5.5% - was strong in 2006, driven by recovery in Europe, steady growth elsewhere in the developed economies, rapid growth in developing economies and stellar growth in India and China. 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 4.25% to 5.25%, Europe from 2.25% to 3.75%, and Japan has ended its policy of 'quantitative easing', raising rates to 0.5%. In UK, interest rates rose from 4.5% to 5.25% (and to 5.5% in May 2007) as inflation worries rose. The Bank of England, and economic commentators, appeared to be surprised by the strength of inflation and were probably too slow to raise rates. The Governor of the Bank of England was forced to write to the Chancellor of the Exchequer in March 2007 to explain why inflation had risen above the 2% - 3% band for CPI (Core Price Index).

3.6 As indicated in Table 1, long-term interest rates were volatile but rose overall during the year. Initially markets anticipated falling short rates – towards 4.25% / 4.5% as inflationary pressures reduced. The interest rate yield (return) curve was inverted for most of 2006 (long term rates are usually higher than short term rates to reflect uncertainty about future inflation rates, but in 2006 long rates exceeded short rates), as pension funds and foreign investors bought gilts at high prices / low yields. However, longer term rates have subsequently risen. The table below shows ten, twenty-five and fifty year PWLB rates during the year.

Table 1 – PWLB Interest rates during 2006/07

	31.03.06 %	**30.06.06 %**	**30.09.06. %**	**31.03.07 %**
10 year	4.55	4.85	4.60	5.05
25 year	4.35	4.55	4.25	4.65
50 year	4.15	4.45	4.10	4.45

STRATEGY AGREED FOR 2006/07

3.7 On the basis of advice from economists, fund managers and in-house research, the Treasury Management strategy anticipated that bank rate would remain around 4.5% in 2006/07. It was expected that in-house deposits would fall marginally to reflect early borrowing to finance the 2006/07 capital programme, 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 rise during 2006/07. 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. (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 former 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 2006/07 - 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 2006/07 which is also on this agenda. The CFR at 31st March 2007 was expected to be £564.1m - the actual was £563.1m. The Prudential Indicators for external debt were as follows:-

Indicator	**Limit**	**Status**
Authorised limit for external debt	£750m	Met
Operational boundary for external debt	£650m	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. In 2006/07 the council undertook a major programme of debt restructuring as set out in paragraph 3.13, but did not exceed the Boundary. The intention of keeping gross borrowing at CFR ensures that borrowing is only undertaken for capital purposes. Under foreseeable circumstances, net borrowing will always be well below CFR.

3.10 The Prudential Indicators for Treasury Management for 2006/07 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%	18%
Maturity of fixed interest loans		
Under 12 months		
- upper limit	40%	2%
- lower limit	0%	0%
12 months – 24 months		
- upper limit	20%	3%
- lower limit	0%	0%
24 months – 5 years		
- upper limit	20%	3%
- lower limit	0%	0%
5 years – 10 years		
- upper limit	60%	17%
- lower limit	0%	0%
Above 10 years		
- upper limit	90%	98%
- lower limit	30%	78%
Upper limit on investments of more than one year	**£60m**	**£50m**

3.11 The various treasury management indicators have been met, with the exception of the upper limit (90%) on exposure to loans above ten years duration. The limit has been exceeded for two reasons. First, the council has undertaken a number of debt restructurings during the year, paying off expensive shorter term debt. Second, debt repaid has been replaced by cheaper long term debt. It should be noted that the 90% limit has been changed to 100% for 2007/08. The indicators 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. Although interest rates were rising during 2006/07, opportunities for long-term lending have been taken, as shown in the table above, when the market has appeared to be too pessimistic about rising rates.

OUTTURN 2006/07 – TREASURY MANAGEMENT

3.12 The Council's treasury portfolio as at 31 March 2007 was as follows:

	31.03.06	**31.03.07**	
	Actual £m	**Planned £m**	**Actual £m**
Fixed rate loans – PWLB	501.3	508.3	528.3
Variable rate loans – PWLB	-	-	-
Variable rate loans – Market	70.5	70.5	75.5
Short-term loans - Market	-	-	-
Total Debt	**571.8**	**578.8**	**603.8**
INVESTMENTS	**100.0**	**80**	**90.8**
NET DEBT	**471.8**	**498.8**	**513.0**

3.13 The value of investments rose as the authority took advantage of low rates to fund part of the 2007/08 capital programme during 2006/07. However, balances were reduced by debt premia (total £22m) paid to the PWLB in 2006/07 as part of early payment of debt. The average rate of interest payable by Brent Council fell from 6.29% in 2005/06 to 5.84% in 2006/07 (falling to 5.15% in 2007/08). In 2006/07 Brent Council has restructured debt and taken out new loans as follows:

a) Debt restructuring. Two major and two smaller debt restructurings were undertaken to take advantage of very low long term rates. In April 2006, £36m of PWLB debt at 4.73% was repaid and replaced by loans at 4.25%. In December 2006, £107m of PWLB debt at 7.95% (£77m of the debt at rates above 9%) was repaid and replaced by PWLB debt at 4.15%. The second restructuring gave rise to debt premia of £17.2m.

b) In addition, a further £18m has been borrowed - £13m from PWLB at an average rate of 4.25%, and a new £5m market loan fixed for an initial period at 4.015%. This was partly to finance maturities totalling £9.5m (average rate 9%), and partly to finance capital expenditure in 2007/08. These were raised when exceptionally low long-term rates were available.

Apart from the £5m market loan, no variable rate borrowing was undertaken because long-term fixed rates fell sharply and offered good long term value.

3.14 As at 31st March 2007, the debt portfolio was as follows:

Maturing Within	31.03.06 £m	31.03.07 £m	Share of Total Debt %	Average Interest Rate 2006/07 %
1 Year	-	9.5	1.6	9.04
1 – 2 Years	9.5	-	-	-
2 – 3 Years	15.0	-	-	-
3 – 4 Years	-	-	-	-
4 – 5 Years	-	-	-	-
5 – 6 Years	-	-	-	-
6 – 10 Years	87.0	-	-	-
10 – 15 Years	15.0	10.0	1.7	8.50
Over 15 Years	374.8	508.8	84.2	5.09
Variable - PWLB	-	-	-	
Variable – Market	70.5	75.5	12.5	4.86
TOTAL	**571.8**	**603.8**	**100.0**	

3.15 The in-house team has lent a total of £1,328.1m (2005/06 £942m) at rates between 4.37% and 5.36%, and at an average rate of 4.83%. The total available to lend fell slightly during the year as the early borrowing to fund the 2006/07 capital programme was spent and as debt premia were funded, before rising at the end of the year when the council took advantage of low rates to fund most of the 2007/08 capital programme early. 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. Economic research and advice from Sector indicated that rates would rise steadily rather than sharply. Loans were made to high quality counterparties included on the Treasury Lending list.

3.16 Other budgetary details for 2006/07 were as follows:

	Budget £m	Actual £m
Interest paid on external debt	36.1	33.8
Interest received on deposits	4.2	5.0
Debt management expenses	0.4	0.2

The reduction on interest paid on external debt reflects savings through restructurings and the impact of the decision to borrow early to fund the 2007/08 capital programme. Borrowing early added to deposits – as the capital payments will not occur until 2007/08 – further increasing interest received on deposits, which had benefited from rising interest rates. The net additional benefit to the General Fund from treasury activities in 2006/07 was £3.2m. The savings have been taken into account in the 2007/08 budget.

EXTERNAL CASH MANAGERS

3.17 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, but Alliance Capital Management was appointed in December 2004. The value of the Alliance's portfolio was £20.4m as at 31st March 2007, whereas Aberdeen's was £20.2m. Actual performance for 2006/07 (2005/06 in brackets), and the three and five years to 2006/07 has been as follows: -

	Aberdeen %	**Alliance** %	**Brent in-house** %	**7 Day LIBID Benchmark** %
2006/07	4. 65(4.79)	4. 41(4.8)	4.83 (4.77)	4.80 (4.67)
Three Years	4.71	-	4.73	4.72
Five Years	4.42	-	4.60	4.33

3.18 Aberdeen underperformed the benchmark in 2006/07. The manager used certificates of deposit during the year, but was unable to cover rising interest rates – an environment which is always hostile to managers. Alliance has marginally outperformed a somewhat different benchmark (a combination of gilts and cash – 4.35% for 2006/07), but returns have been disappointing when compared to those of other managers.

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. The downside of this is that some loans made in 2006/07 are yielding less than market rates in 2007/08 as rates have continued to rise.

3.20 The five year record indicates that Aberdeen has outperformed during the period, but not achieved their outperformance target (+0.5% per annum). However, Aberdeen is among the best managers over all periods, which have seen low and falling gilt yields.

TREASURY ADVISER

3.21 Sector Treasury Services, a subsidiary of the Capita Group, has acted as Treasury Adviser to the Director of Finance and Corporate Resources for a number of years. The contract was reviewed in early 2007, with the result that Butlers, a subsidiary of the ICAP Group, was appointed to a three year contract. It is felt that the council will benefit from working with very professional staff using a slightly different approach, as well as from a small saving from lower fees.

DEVELOPMENTS SINCE THE END OF THE YEAR

3.22 The market anticipates that short-term interest rates may rise to 5.75% / 6% during the remainder of 2007/08. It is also anticipated that there may be opportunities for debt restructuring in 2007/08 if long-term rates rise further. Currently, long-term rates have risen sharply to reflect concerns about inflation and liquidity within financial systems. If the low interest rate scenario has ended, this will have implications for future budgets. However, it is believed that global imbalances – large sums flowing out of Far and Middle Eastern economies looking for safe havens – will continue to keep long rates lower than economic theory might suggest.

3.23 The current external management arrangements, using two managers, have been in place since 1998. The new adviser, Butlers, has suggested a review on the basis that investment targets are not being met and that there may be opportunities arising from the revised regulatory structure introduced following the 2003 Local Government Act. These opportunities may include more use of credit worthy pooled funds and wider discretion for managers to help them improve returns whilst controlling risk.

4 FINANCIAL IMPLICATIONS

As set out in the report, the Council made savings on external interest paid in 2006/07 mainly as a result of debt restructuring. Interest on cash balances also rose during the year as balances and interest rates increased. The additional savings to the General Fund in 2006/07 were £3.2m. The savings generated in 2006/07 have been taken into account in the 2007/08 budget.

5 STAFFING IMPLICATIONS

None.

6 DIVERSITY IMPLICATIONS

This report has 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

Treasury Policy Statement and Treasury Systems document.

Sector and Butlers - 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 2005/06 – July 2006; 2006/07 Budget Reports on Treasury Strategy and Prudential Code, and Annual Investment Strategy – February 2006

9 CONTACT OFFICERS

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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