# SECTION 10

## 10. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY 2011/12

### Introduction

10.1 This section of the report presents:

a. The 2011/12 Treasury Management Strategy setting out the proposed borrowing and lending policy and the factors influencing this over the coming year.

b. The 2011/12 Annual Investment Strategy setting out the security of the investments made by the authority.

10.2 Under the Local Government Act 2003, local authority borrowing is regulated by the Prudential Code, details of which are set out in Section 11 of the Budget Report, and the requirement for an Annual Investment Strategy.

10.3 Members are asked to agree

a) The Treasury Management and the Annual Investment Strategies for 2011/12 as part of the main recommendations to the report.

### Regulatory Requirements

10.4 The 2009 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 each 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.

10.5 Guidance issued under Section 15 (1) (a) of the Local Government Act 2003 also requires that authorities should prepare an Annual Investment Strategy (AIS) to be agreed by Full Council before the commencement of each year. The AIS is required to 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 also has to set out the maximum periods for which funds may prudently be committed (liquidity). 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 does not invest treasury balances in shares, corporate bonds or floating rate notes issued by companies except through pooled schemes.

10.6 The Department for Communities and Local Government (DCLG) issued revised Guidance in 2010 following the collapse of Lehman Brothers and

various Icelandic banks, and the House of Commons Select Committee report on local authority investments in Icelandic banks. The Guidance main points are:-

a) Security and liquidity are the key issues in lending. There should clear policies on the duration of loans, and the share of the portfolio that can be lent for longer periods.
b) The Treasury Strategy should be approved by Full Council. Authorities should consider sending revised strategies to members during the year.
c) The Treasury Strategy should be published.
d) Local Authorities should not rely solely on credit ratings but consider other information.
e) The Treasury Strategy should comment on the use of advisers.
f) The Treasury Strategy should comment on the investment of money borrowed in advance of need. The Guidance confirms that it is legitimate for authorities to borrow in advance, but is concerned that the consequent loans into the market should be legitimate and not be speculative.
g) The Treasury Strategy should comment on how staff training is reviewed and training needs met.
h) The Treasury Strategy should include proposals for regular scrutiny by members.

The proposed AIS for 2011/12 is attached as Appendix L.

**Economic Background**

10.7 The international economic background in 2008 was extremely volatile, with rising oil and commodity prices, and a credit crisis that led to the collapse / takeover / rescue of various banks as inter bank lending and the wider provision of credit reduced. In 2009, recession (the UK economy shrunk by 4.5%), low interest rates (UK 0.5%) and stock market recovery (up by 50% since the trough in March) were the main features. In 2010, growth resumed, as follows:-

a) Economic growth was positive. The UK economy grew by around 1.4%, Europe 1.5%, USA 2.7%, China 10%, and the World economy by 4.3%.
b) Stock markets rose by around 10% - 15%.
c) In UK, house prices were stable overall, rising in London and the South East but falling elsewhere. Commercial property prices continued to recover during the year.
d) Despite the previous recession and low wage increases, and contrary to expectations, UK inflation rose by 3.7% in 2010, driven by rising commodity prices, an increase in VAT and the decline in the value of sterling.

e) Short term interest rates have remained very low (UK 0.5%, USA 0% - 0.25%, ECB 1%) as Central Banks have sought to support economic activity and recapitalise the banks. Longer term rates have been held down by quantitative easing in UK and USA.

10.8 Looking ahead to the next financial year, it is expected that world economic growth will slow marginally to around 4% in 2011, led by growth in emerging economies such as China and India (8.5% - 9%) but restrained by lower growth in some developed countries and falling output in such countries as Ireland and Greece. Although the USA economy should grow by around 3% in 2011, it is anticipated that UK and Europe will only grow by around 1% / 2%. Reductions in public expenditure and tax increases may reduce growth rates further. Interest rates should continue to be very low – UK Bank Rate may remain at 0.5% throughout 2011, possibly rising to 1% towards the end of the financial year. Inflation may continue to be a concern - at present CPI (3.7%) is well above the Bank of England target rate of 2%, and may rise further in 2011 as a result of commodity price rises, VAT increases and the previous fall in the value of sterling. However, low pay increases (only 2.1% per annum in the year to December), unemployment and unused capacity should reduce inflation in 2012. Long-term interest rates may rise as governments borrow money to fund recovery programmes, but high saving rates in Asia may restrain large increases. However, the government has increased interest rates charged by the Public Works Loans Board, so that any council borrowing will be more expensive.

**Financial Market Background**

10.9 The sub-prime crisis and credit crunch of 2007 – 2009 led to the collapse of a number of banks, either into nationalisation, forced mergers or disappearance. However, the collapse of Lehman Brothers – a key broker and investment bank – in September 2008 caused a financial tsunami to overrun the banking system.

10.10 Although there has been progress in repairing the banking system through quantitative easing, recapitalisation and regulatory activity, there remain a number of issues to solve. In USA, new regulations (to reduce the opportunity for banks to trade) are only partially in effect. The housing market in USA, with widespread negative equity, will take years to recover. In UK, the housing market remains fragile as lenders restrict credit, so that prices may fall by a further 10% in 2011. Further, there are many other commercial property and other loans that remain on the brink of default. In Europe, bank debts are causing both nationalisation and restructuring of the banking sectors, and rising interest rates on sovereign debt. These factors have meant that Brent has continued to restrict the Lending List to UK institutions.

10.11 The collapse of Lehman Brothers, and the financial turmoil that followed, caused three Icelandic banks to be put into administration when their credit ratings were reduced and they were unable to meet short term obligations. Brent had two deposits outstanding, as follows:-

| | | | |
|---|---|---|---|
| Heritable Bank | £10m | Lent 15.08.08 | Repayable 14.11.08 |
| Glitnir Bank | £5m | Lent 15.09.08 | Repayable 12.12.08 |

To date, the council has had £5m returned by the administrators of Heritable Bank, who suggest that depositors will recover at least 80% of their original sum. It is anticipated that the £5m deposited with Glitnir will be returned as legal advice is that the deposit will be treated as a preferential creditor However, progress is likely to be slow in the light of legal challenges, especially from the winding up Board for the Bank. If the deposits are not returned in 2011/12, the lost interest will be around £50,000 (assuming an interest rate of 0.5%). The council is making provision for non-repayment of £2m in the 2010/11 accounts.

10.12 In the light of the turmoil on the financial markets, the Lending List agreed by the Director of Finance & Corporate Services was reconstructed to reduce risk by the removal of foreign and lower rated UK banks, and Building Societies. In March 2009 and October 2010 the council made early repayment of loans from the PWLB valued at £64.75m and £50m., thus generating substantial savings (£2.2m per annum) and reducing balances available to deposit with other banks (currently at very low interest rates). The repayment reduced council long term borrowing to £586.5m, around £60m below the anticipated level of the Capital Financing Requirement at the end of financial year 2010/11.

**Lending Policy**

10.13 Treasury management is defined as the management of the organisation’s cash flows and its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

10.14 Table 10.1 indicates the projected summary cash flow for the authority. It is anticipated that cash balances will be approximately £30m by 31st March 2012 if the council takes £75m in short term borrowing and resumes long-term borrowing.

**Table 10.1 - Cash Flow Summary 2011/12**

| | £m | | £m |
|---|---|---|---|
| **Cash Balances as at 1 April 2011** | | | **-20** |
| Capital programme (including BHP loans) | (100) | | |
| Debt repayment (including premia) | (2) | | |
| | | | (102) |
| | | | (122) |
| Repayment by Heritable<br>Capital receipts/grants | 2 | | |
| Payment of debt premia | 5 | | |
| Long-term borrowing | 54 | | |
| Short term borrowing | 75 | | |
| Minimum Revenue Provision | 11 | | 147 |
| | | | |
| **Cash Balances as at 31 March 2012** | | | **25** |
| **Total long-term borrowing as at 31.03.11** | | | **586** |

10.15 In 2010 it was felt that the market had recovered significantly and that debt defaults would reduce. Following consultation with the adviser, first Butlers then Arlingclose, and a report to the Audit Committee, the former Director of Finance and Corporate Resources increased loan duration to one year, reinstated a suitably rated building society to the lending list and increased the size of loans to local authority and government institutions. The construction of the list also utilises credit analysis undertaken by Arlingclose. The current list is as shown in Table 10.2 below.

**Table 10.2 – Current Brent Lending List**

**A. UK BANKS – UP TO £10M for INDIVIDUAL banks or Banking GROUPS, or building societies as indicated below**

**Rated AA- or above long, F1+ short term, B/C or above individual, 1 support (unless part owned by the government or supported by an implicit guarantee). Up to one year**

Bank of Scotland
Lloyds Bank – linked with Bank of Scotland as part of Lloyds

Barclays Bank PLC
HSBC Bank
Clydesdale / Yorkshire Bank
Santander UK Ltd

National Westminster
Royal Bank of Scotland – linked with Nat West as part of the RBOS group

Nationwide building society

**B. MONEY MARKET FUNDS –UP TO £12M**

**Rated AAA**

Royal Bank of Scotland
Morgan Stanley Cash Fund
Northern Trust

**C. DEBT MANAGEMENT OFFICE – NO LIMIT – up to one year**
**D. OTHER LOCAL OR GOVERNMENT AUTHORITIES – up to one year**
**E. SUPRANATIONAL INSTITUTIONS – UP to £10M**

**AAA** long term and F1+ short term ratings that are supported by major international organisations such as the USA FED or the European Central Bank. These have only ever been used by external managers

10.16 The 2009 CIPFA Code of Practice in Treasury Management recommends that authorities should have regard to the credit ratings issued by all three main rating agencies, and make their decisions on the basis of the lowest rating, as well as to seek independent credit research. Two of the British banks, Royal Bank of Scotland and Lloyds, are rated lower (A+) by one of the rating agencies, but they have not been removed from the lending list on the grounds that they are part owned by the government as well as supported by an implicit government guarantee that allows them to issue certificates of deposit.

10.17 Over the longer term there are operational difficulties in running a reduced Lending List and a cost in foregone interest receipts. It is proposed that, if market conditions remain calm, the Council returns to using a longer Lending List in April. The Lending List will incorporate features outlined in the 2010

Treasury Strategy report, such as sovereign ratings, a limit of 20% on individual country exposure, with the exception of UK, no deposits with companies or countries that are on a negative rating watch, maximum deposit of £10m apart from government related agencies and AAA rated money market funds, and maximum lending period reduced to three years (with senior management approval).

10.18 Details of the basis on which credit ratings are used are set out in Table 10.3 below.

**Table 10.3 – Use of Credit Ratings**

a) The credit rating agencies (Fitch, Moody's and Standard & Poor) meet with financial institutions, review their financial prospects and issue ratings.

b) The main source of ratings used by Brent is Fitch, which uses four sets of criteria which can be used as an overall grid. This approach should reduce risk, and is followed by a number of other authorities – though some authorities only use two ratings (long term credit and short term credit). The other two rating agencies do not issue support ratings.

c) The Fitch ratings are as follows:

  i. Long term credit ratings are a benchmark of probability of default. The scales are split between investment and speculative grade – Brent only uses investment grade, which is spread from AAA – highest credit quality – to BBB – good credit quality.

  ii. Short term credit ratings are a benchmark of the probability of default, but with a 13 month time horizon. These are usually most relevant to our activity. The scale spreads from F1 (P1 for Moody's) – highest credit quality – to D, which is default.

  iii. Individual ratings are assigned only to banks and attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. The rating looks at soundness of balance sheets and business models. There are often no ratings for subsidiaries. The scale spreads from A, a very strong bank, to F, a bank that has either defaulted or would have defaulted had it not been given support.

  iv. Support ratings indicate whether or not the bank will receive support should this be necessary. The scale spreads from 1, extremely high probability of external support, to 5, where support cannot be relied upon.

10.19 The Council uses these ratings to establish its lending list, but also includes institutions that have been accepted by the UK government's credit guarantee scheme. It is felt that admission to the scheme indicates that the institution is too significant to the economy to be allowed to default.

10.20 At present, the investment company, Aberdeen Asset Management, manages an external portfolio valued at £23m, whereas the in-house manager has around £40m. The external manager follows the Brent lending list, and is allowed to use certificates of deposit (CDs), supranational bonds, government gilts and cash to enable them to improve performance, with a target of outperforming their benchmark by 0.5% per annum. The manager has outperformed substantially in recent years using longer dated (one year) CDs.

It is felt prudent to retain external managers with different benchmarks, encouraging diversification. However, changes to the borrowing policy to reflect very low interest rates and the recent increase in PWLB lending rates may mean that the council reduces the funds placed with an external manager.

10.21 As set out above, rates are at 0.5% and are expected to remain at that level or rise marginally (to 1%) during the year. In-house activity will seek to lend for longer periods when appropriate, and use money market funds to add extra yield. However, reduced cash balances following previous restructurings will ensure that most cash is used for day to day cash flow purposes. The 2011/12 budget assumes that Brent will receive further payments from Heritable bank (£2m), but no payments from Glitnir, and that there will be no interest paid on deposits that are outstanding.

**Borrowing Policy**

10.22 Long-term interest rates have been volatile during 2010/11. Initially rates fell as a result of Quantitative Easing and the flight to safety during the Greek debt crisis. Recently, gilt rates have recovered (50 year gilts 4.3%, PWLB 5.3%) as markets looked at high levels of gilt issuance and economic recovery. It is anticipated that long-term rates may rise further in 2011/12 as the world economy recovers and inflation worries increase, but there are conflicting pressures. Rates may be reduced as a result of further quantitative easing, increases in taxation / reductions in government expenditure, or as a result of high saving levels in Asia. The budget uses a prudent assumption of a mix of short term borrowing and some longer term borrowing at an average interest rate of 5%.

10.23 Borrowing policy in 2010/11 will be determined by a number of factors:

a) The capital programme for 2011/12, including the new Civic Centre (£47m), and loans to Brent Housing Partnership for new houses (£46m).

b) The cost of loans from the PWLB. Previously the PWLB charged local authorities a 0.15% margin over government gilt rate when they took loans. In October 2010, the margin was increased to 1%, increasing pressure on councils to reduce capital programmes, borrow from other sources and to use internal resources (balances) rather than borrow externally.

c) 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 had previously indicated that CFR has been the most economical level for the authority's long-term debt. However, whereas before 2008 the interest rate curve had been 'inverted', with long term rates lower than short term rates, the curve has now normalised so that it may be advantageous not to borrow up to CFR but use relatively cheaper, short term debt and reduce lending to the market. However, if long term rates are expected to rise to allow the government to fund its

deficit through gilt issuance, it may be advantageous to take long term debt despite the short term cost. Alternatively, if short-term interest rates remain low, 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.

d) The need to borrow. The cash flow summary indicates a need to borrow in 2011/12 if the target is CFR.

e) 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 remain very low and that the risk premium is lower. Market commentators are concerned that inflation may remain high, though the Bank of England believes that inflation will fall in 2012 .

f) The prudential limits to borrowing as agreed by Full Council (see Prudential Code section of the Budget Report, Section 11).

10.24 It is proposed to borrow a further £67m long term in 2011/12 for the main capital programme and BHP. Officers will also look at market forecasts to confirm the advantages/disadvantages of borrowing early to fund major developments. Additional loans may also be taken if restructuring opportunities are evident or anticipated.

10.25 The Department for Communities and Local Government (DCLG) has proposed a reorganisation of housing finance in 2012, involving the repayment of housing revenue account debt. It may be necessary to amend the borrowing programme or undertake preparatory debt restructuring to minimize any adverse implications to the General Fund.

**Prudential Indicators**

10.26 Under the revised Treasury Management Code issued in 2009, the treasury prudential indicators are to be included within the treasury management strategy report. The Code requires increased analysis of loan duration, so that all loans above ten years are shown in ten year bands. The prudential indicators are as follows:

a. Adoption of the CIPFA Code of Practice for Treasury Management. This was adopted by the Council in September 2002. Amongst other things, it requires publication of an annual treasury management strategy, a mid-year report and an outturn report.

b. Exposure *to changes in interest rates:*

   - *Upper limit on net borrowing at fixed interest rates.* This has been set at 100% on the basis that all net borrowing may be at fixed rates if it is anticipated that short-term rates are set to rise and long-term rates are perceived to be low. Variable interest borrowing would be retained up to the level of any variable interest investments;

- *Upper limit on net borrowing at variable rates.* This has been set at 40%. Variable rate borrowing is held as a hedge against variable rate investments. It also may be held where variable interest rates are low compared to fixed rates and fixed rates are expected to fall. The upper limit has also been set with debt restructuring in mind.

c. *Maturity structure of borrowing.* Upper and lower limits on proportion of fixed interest loans that mature in:
   - Under 12 months;
   - Between 12 months and 24 months;
   - Between 24 months and 5 years;
   - Between 5 and 10 years;
   - Between 10 and 20 years
   - Between 20 and 30 years
   - Between 30 and 40 years
   - Between 40 and 50 years

   The limits have been set to allow flexibility to manage loan durations but also to avoid having too much exposure to maturing loans in any period.

d. *Total investments.* The limit proposed allows flexibility for either external managers or the in-house team to lend for longer periods than one year if interest rates make this advantageous. The limit has been set at £40m to reflect lower balances.

**Table 10.4 Prudential Indicators for Treasury Management**

| | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
|---|---|---|---|---|---|
| Treasury Management Code adopted | Yes | Yes | Yes | Yes | Yes |
| Exposure to interest rate changes: Upper limit on fixed rate interest (% of net borrowing) | 100% | 100% | 100% | 100% | 100% |
| Upper limit on variable rate interest (% of net borrowing) | 40% | 40% | 40% | 40% | 40% |
| Maturity of fixed interest borrowing: | | | | | |
| Under 12 months:<br>o Upper limit<br>o Lower limit | 40%<br>0% | 40%<br>0% | 40%<br>0% | 40%<br>0% | 40%<br>0% |
| Between 12 and 24 months:<br>o Upper limit<br>o Lower limit | 20%<br>0% | 20%<br>0% | 20%<br>0% | 20%<br>0% | 20%<br>0% |
| Between 24 months and 5 years:<br>o Upper limit<br>o Lower limit | 20%<br>0% | 20%<br>0% | 20%<br>0% | 20%<br>0% | 20%<br>0% |
| 5 to 10 years:<br>o Upper limit<br>o Lower limit | 60%<br>0% | 60%<br>0% | 60%<br>0% | 60%<br>0% | 60%<br>0% |
| 10 to 20 years: (**Note –** similar limits for 20–30, 30–40 and 40–50 years)<br>o Upper limit<br>o Lower limit | 100%<br>0% | 100%<br>0% | 100%<br>0% | 100%<br>0% | 100%<br>0% |
| Upper limit on Investments of more than one year: | £40m | £40m | £40m | £40m | £40m |

### Debt Restructuring

10.27 Many long-term loans were borrowed from the PWLB during periods when interest rates were 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.

10.28 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 without incurring a penalty. Local authority debt is regarded as of high quality to lending institutions that are keen to grow such business on their loan books. To date Brent has taken 15 LOBOs, valued at £95.5m. The council may take more LOBOs if opportunities arise, subject to limiting council's exposure to potential increases during the period of the loan.

10.29 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.

10.30 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 (PWLB), has changed its terms to charge a larger premium on debt repaid prematurely.

### Member Engagement

10.31 Before 2008, two Treasury Management reports were made each year, unless important issues arose. The reports were the Strategy report, when setting the budget, and the Outturn report at year end. However, since the collapse of Lehman Brothers and the default of the Icelandic banks, there have been reports on lending activity to each meeting of the Audit Committee, setting out deposits at the end of each quarter and how the lending list has changed over the period. Other papers have detailed the report of the Commons Select Committee on local authority lending to Icelandic banks, the revised CIPFA Treasury Management Code of Practice and the DCLG Guidance on local authority investments.

10.32 The revised CIPFA Treasury Management Code of Practice makes some changes to previous practice, as follows:-

a) A mid-year review of the annual treasury strategy to Full Council, looking at activities undertaken and any variation from agreed policies / practices.
b) The Audit Committee is to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.
c) The Director of Finance and Corporate Services is to ensure that members tasked with treasury management responsibilities have access to appropriate training opportunities

As part of this, a training session for members was held in November 2010, and attended by 16 councillors. It is also proposed that this treasury management strategy and the annual investment strategy are considered by the Audit Committee at its meeting in February 2011.