PERFORMANCE REVIEW TEAM

2009/10 Treasury Management Progress Report to 30 June 2009

Report of Head of Financial Services

1. Introduction

It is a requirement of the CIPFA Code of Practice on Treasury Management that regular monitoring reports are presented to Members on treasury activities. These reports will normally be presented soon after the end of June, September, December and March.

Cabinet approved the Treasury Strategy for 200/10 on 17 February 2009 and the Investment Strategy was approved by Council at its meeting on 04 March 2009. This report outlines activities undertaken in pursuance of those strategies during the financial year.

2. Summary

- The first dividend payment (of £410K) has been received in relation to Icelandic investments. Other recovery work is progressing, although there is no further formal update on prospects overall – further information is awaited.
- There have been no breaches of Prudential Limits or the approved Investment Strategy in the quarter.
- All of the £8.5M temporary borrowing brought forward from 2008/09 has been paid off (in line with cash flow expectations for the first quarter of the year).
- Whilst currently there is a favourable variance against budget, by the end of year it is expected that treasury activity will be budget neutral, excepting Icelandic investment implications.

3. Icelandic Investments Update

The last financial update was included in the annual treasury report, which went to Cabinet in July. This was based on the information contained within the draft accounts for last year, but since then the following points may well change expected returns:

- The latest update from the Local Government Association (LGA) indicated that the recovery rates for Landsbanki are now expected to be around 83% (as compared with 95% assumed within the accounts).

- Claim information has now been sent to the solicitors (Bevan Brittan) acting in connection with Landsbanki and Glitnir, to allow formal claims submission by the end of September. The claims will cover costs (such as legal costs) incurred, contractual interest, and penalty interest. Amounts relating up to 22 April 2009 will have the same ranking as the original principal amounts invested (i.e. currently preferential, subject to the outcome of any legal challenges). If priority status is retained, the interest elements of the claims could be substantial – but clearly this not yet certain, and loss of priority status would see prospects for recovery deteriorate far more significantly.

- The first dividend from KSF has been received, amounting to £410K (20% of the claim). This is higher than the 10% expected and it is possible that a further dividend may be paid out in the autumn. As yet, however, there is no further update on total expected returns. (The accounts were based on a 50% total).

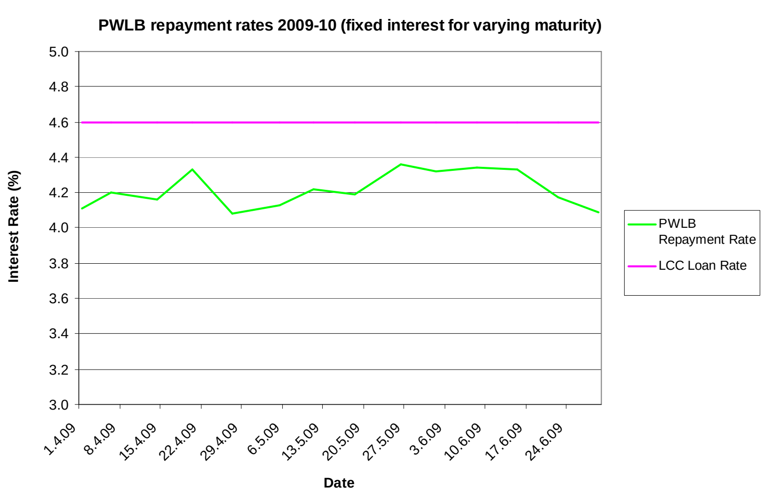
4. Debt Portfolio

The Council had £8.5M of short term (temporary) loans as at the start of the Quarter. With new-year local tax receipts coming in and fixed term investments maturing, at the end of Quarter 1 the Authority had repaid all such temporary borrowings.

The opening level of longer term debt for the period was £39.4M. During the quarter, in cash flow terms there was no new long term external borrowing required, despite the Council's Capital Financing Requirement being around £45.8M at the start of the period. The closing balance of longer term debt was therefore still £39.4M - the bulk of this relates to Public Works Loan Board (PWLB) loans of £39.2M. This is well within the Operational Boundary, which is set at £56M. All of the Authority's debt is currently fixed term and due to mature in 10 or more years. This means that during the quarter the Authority was within all relevant Prudential Limits (see ***Appendix A*** for full listing of indicators).

There is no immediate need to take out new long term loans at present to help fund capital investment, because cash flow is still relatively strong, despite the difficulties with Icelandic investments. In very broad terms, this is primarily because of the amounts being set aside each year from the budget for the future repayment of debt, through the Minimum Revenue Provision (MRP). At present it is still favourable to avoid taking out any new longer term borrowing. This is because there is less resulting counterparty risk involved and new long term loans would cost more than the investment returns, if the Authority were to invest an equivalent sum.

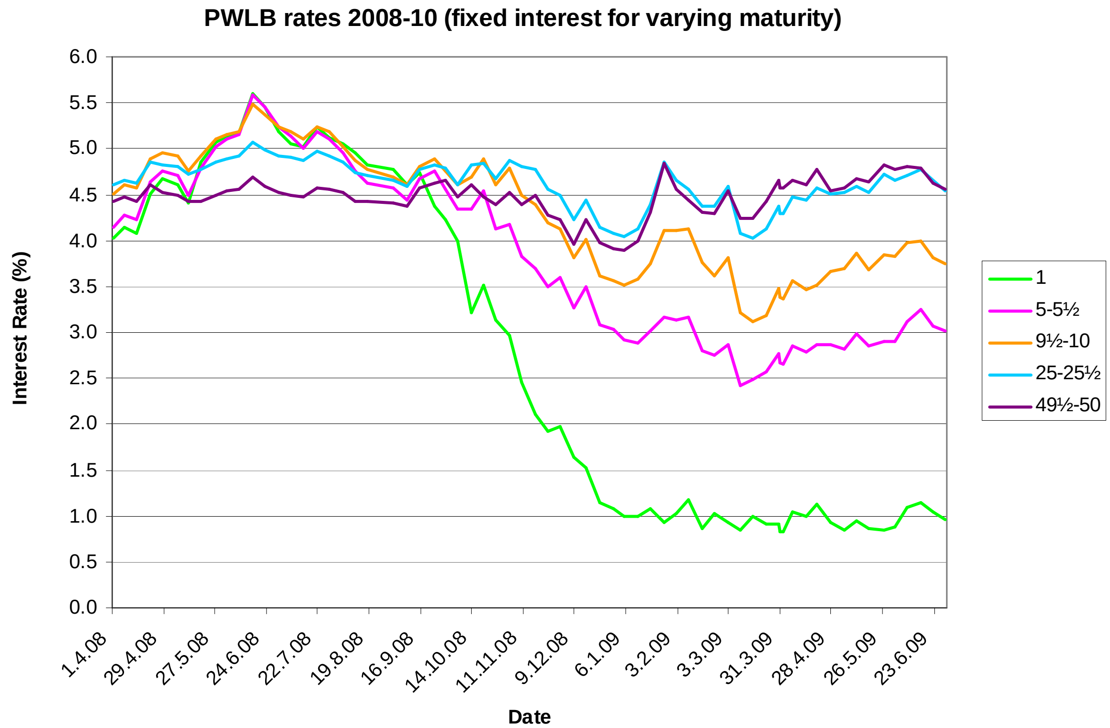
Further repayment of existing PWLB loans is also an attractive alternative to investing surplus cash, given ongoing counterparty risks and current returns, but there are premiums attached to early repayment. These premiums depend on the difference between the fixed rate on any existing loan compared to the PWLB's repayment rate. Currently the Council's cheapest material loan balances are fixed at 4.6%, as compared to the repayment rate from the PWLB, which at the end of Quarter 1 was 4.09%. Only if the repayment rate reaches or surpasses 4.6% would there be no premium to pay. The chart below shows how the repayment rate for long term loans has fluctuated over the first quarter of 2009/10 and it is clear that over a 3 month period this rate is quite volatile. The position will be monitored going forward through 2009/10.



It is worth highlighting that Government has been recommended to review such costs of repaying debt, as part of the Audit Commission's report into Icelandic investments,

5. Current Borrowing Rates

The graph below shows that the rate for short term (1 year) borrowing has seen a sharp decline to around the 1% level over the last year. Medium term borrowing (5 to 10 years) has seen a less dramatic reduction to around the 3% level. Long term rates have fluctuated around the 4.5% level. Quarter 1 has seen these differences stabilise such that there is a broad range of rates, depending on the term of the borrowing.

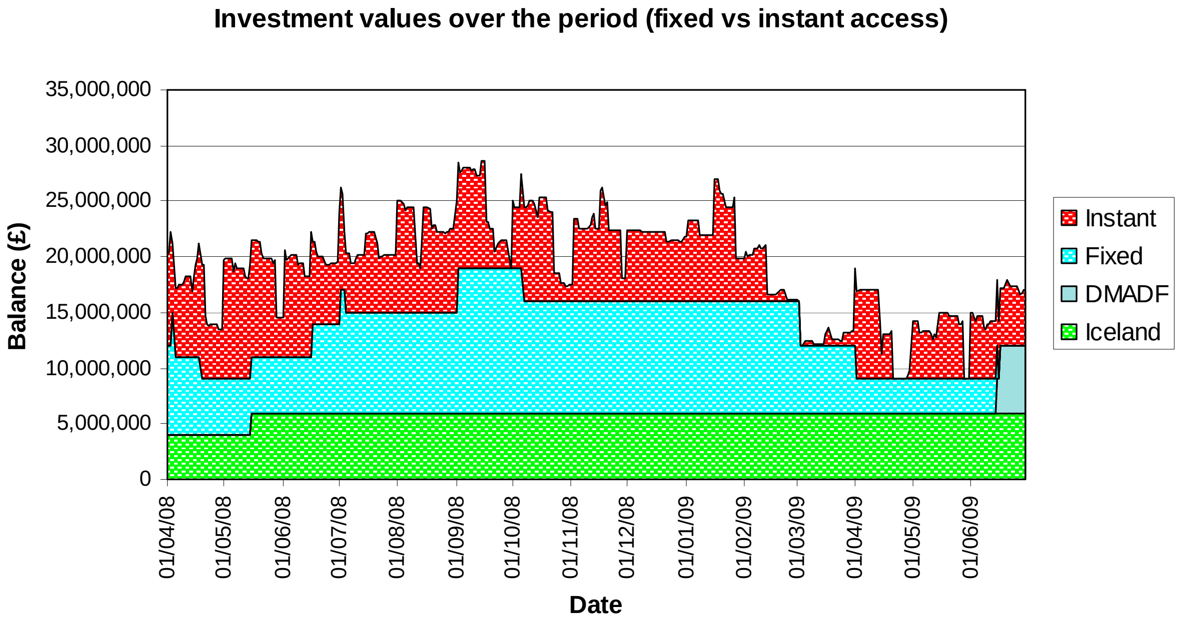


6. Investing Activities

As laid down in the approved Investment Strategy, the aim is to prioritise security and liquidity of the Authority. This is to minimise any further chance of a counterparty failing and the Council not being able to remove its deposits, as happened with the Icelandic banks.

All investment activity has been in line with the approved Treasury Strategy for 2009/10. No fixed term investments have been placed since September 2008, with the exception of Debt Management Accounts Deposit Facility (DMADF) deposits (i.e. with Government). Any other surplus cash has been managed on a day to day basis using the call accounts. A full list of the investments placed during the year is enclosed at ***Appendix B***.

The split of fixed term investments and the balances held within the call accounts is shown graphically overleaf (see also further details in ***Appendix B***). During the quarter the last two non Icelandic fixed term deposits matured. Furthermore, a comparison between Quarter 1 this year and Quarter 1 2008/09 shows that overall there is less cash deposited. This can be explained primarily by the £5.6M that was used to repay PWLB loans in January 2009.



7. **Summary of Budget Position and Performance at 30 June 2009**

In terms of performance against external benchmarks, the return on investments compared to the LIBID and bank rates over the year to date is as follows:

Base Rate	0.50%
3 Month LIBID	1.33%
Lancaster CC Investments	2.45%
Lancaster CC investments*	1.42%

*This rate includes £6M frozen in Icelandic banks, at 0%.

This performance appears good but it should be noted that it is affected by fixed term investments that were taken out before the global economic down-turn.

In terms of performance against budget, the details are as follows:

Annual budget	£71K
Profiled budget	£17K
Actual to date	£50K (see details in ***Appendix B)***
Variance	£27K (favourable)

The reason for the favourable position is due to the fixed term investments which were taken out when rates were higher; this skews income towards the first part of the year. The £71K budgeted figure is still judged to be a good estimate of the final out-turn, however. To illustrate how dramatic the change in economic conditions has been over the last 12 months, actual interest earned in 2008/09 was more than ten times the current year's budget of £803K (not including any Icelandic bank interest).

It is highlighted that in this year, investment interest budgets have not yet been updated to take account of the changes resulting from the accounting requirements for Icelandic investments. As reported at outturn, an additional £271K interest will need to be budgeted for, but it is assumed that this would be used to make some further provision for expected losses. This would leave £930K provision still to be made – although as mentioned earlier, such estimates will change over time, and therefore need reviewing and updating regularly.

8. Risk management

The main focus of risk within treasury management currently is security of deposits and their liquidity. The Council's investment strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and length of deposit, together with supporting advice. Officers have been maintaining the portfolio well within the agreed limits by utilising instant access call accounts and avoiding any new fixed term investments except for short term deposits with the DMADF. The view is, therefore, that associated risks have reduced over the period and are low, as at 30 June. Over the next quarter, it is currently expected that they will stay low, but that AAA rated Money Market Funds will also be used (in accordance with the Strategy), to create additional capacity at fractionally better rates.

There is also a liquidity risk associated with needing access to cash on a day to day basis. There were £8.5M of short term borrowings at the start of the period, all of which have now been repaid. At the end of the period the Authority had cash balances of £16.9M, £4.9M of which was held on instant access and £6M of which was due to be returned by the DMADF on 06 July, to coincide with precept demands. As such, liquidity is not judged to be significant risk at the present time.

Aside from the above, there is also financial risk attached to the longer term debt portfolio, associated with interest rate exposure. Until such time as PWLB repayment rates improve though, as mentioned earlier, there are unlikely to be any further actions that can be taken to improve further the Council's position.

Finally, with regard to recovery of Icelandic investments, this is being managed with the support through the Local Government Association and it is judged that this is the most effective way of maximising recovery on the Council's behalf.

9. Conclusion

The first quarter of the year has been relatively uneventful for Treasury Management. Over the quarter there have been no breaches of counterparty limits or other prudential indicators. The Authority is starting to see the full impact of interest rate reductions on investment returns although performance against budget is good due to interest from the last remaining fixed term investments. These are still returning at rates of interest prevalent 12 months ago.

Given the current economic climate and in line with the investment strategy, the HM Treasury debt management office account is now being used as a safe haven for deposits of surplus cash. This has been a useful way to manage counterparty risk as fixed term investments have matured, leaving cash that in prior years would have been placed as medium-term fixed deposits.

The information currently available regarding Icelandic investments gives some cause for optimism that the Council will get back the majority of principal invested. Definitive statements from the administrators are still awaited, however.