Appendix C

2014/15 Treasury Management Progress Report 30 June 2014 (Quarter 1)

Report of Chief Officer (Resources)

1. Introduction

The CIPFA Code of Practice on Treasury Management requires that regular monitoring reports be presented to Members on treasury activities. These reports will normally be presented after the end of June, September, December and March as part of the Council's performance management framework.

Council approved the 2014/15 Treasury Strategy, which incorporates the Investment Strategy, at its meeting on 26 February 2014. This report outlines activities undertaken in pursuance of those strategies during the financial year up to the end of Qtr 1.

Treasury management is a technical area. To assist with the understanding of this report, a glossary of terms commonly used in Treasury Management is attached at ***Annex A***. In addition, the Councillor's Guide to Local Government Finance also has a section on treasury and cash management and an updated Guide is now available through the Member Information section on the Intranet.

2. Summary: Headline Messages

- **Icelandic Investments** – Only £77K still due from KSF, and £615K held in an escrow account in respect of Glitnir.

- **Borrowing Activities** – no new borrowing has been undertaken during the first quarter of the year.

- **Investment Activities** – two call accounts have reduced their interest rates, however, two £3M fixed term investments have been placed. Overall, investment interest is £10K ahead of target at the end of the first quarter.

3. Economic update (provided by Capital Asset Services)

After strong UK GDP growth of 0.7%, 0.8% and 0.7% in Quarters 2, 3 and 4 respectively in 2013, and 0.8% in Q1 2014, it appears very likely that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Accordingly, markets are expecting a first increase in the base rate around the end of 2014.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May, and the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed in this quarter.

In June, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $35bn and are expected to stop by Q3 201, providing strong economic growth continues this year. First quarter GDP figures were depressed by exceptionally bad winter weather, but growth rates since then look as if they are recovering well.

The Eurozone is facing an increasing threat from deflation. In May, the inflation rate fell further, to reach 0.5%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June to loosen monetary policy in order to promote growth.

4. Icelandic Investments Update

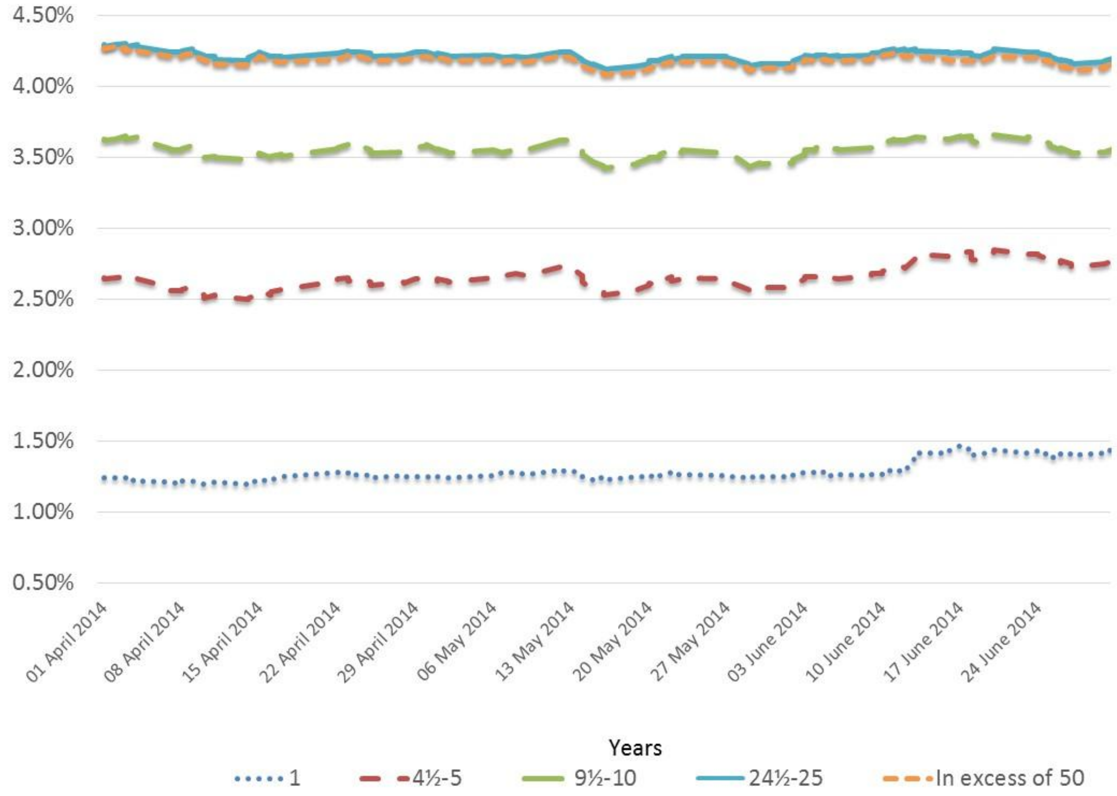
There has been no further distributions associated with the Council's only outstanding claim (with KSF). The outstanding money associated with Glitnir is slightly different in that the original claim has been repaid but is being held in an Icelandic bank escrow account, none of which can be repatriated as yet.

The following table shows the outstanding balances:

	KSF	Glitnir	Landsbanki	Total
	£000	£000	£000	£000
Original Deposit	**2,000**	**3,000**	**1,000**	**6,000**
Claim	**2,048**	**3,173**	**1,121**	**6,342**
GBP Payments received	1,669	2,508	1,021	5,198
Amounts still held in escrow account	**0**	**615**	**0**	**615**
Total anticipated recovery (%)	85.25%	100%	92%	
Further payments due (%)	3.75%	0%	0%	
Further payments due (£)	**77**	**0**	**0**	**77**
Total anticipated receipts	**1,746**	**3,123**	**1,021**	**5,890**

5. Borrowing Activities

No new borrowing was undertaken during Qtr 1. The following graph shows the PWLB rates for the last three months ending 30 June 2014.

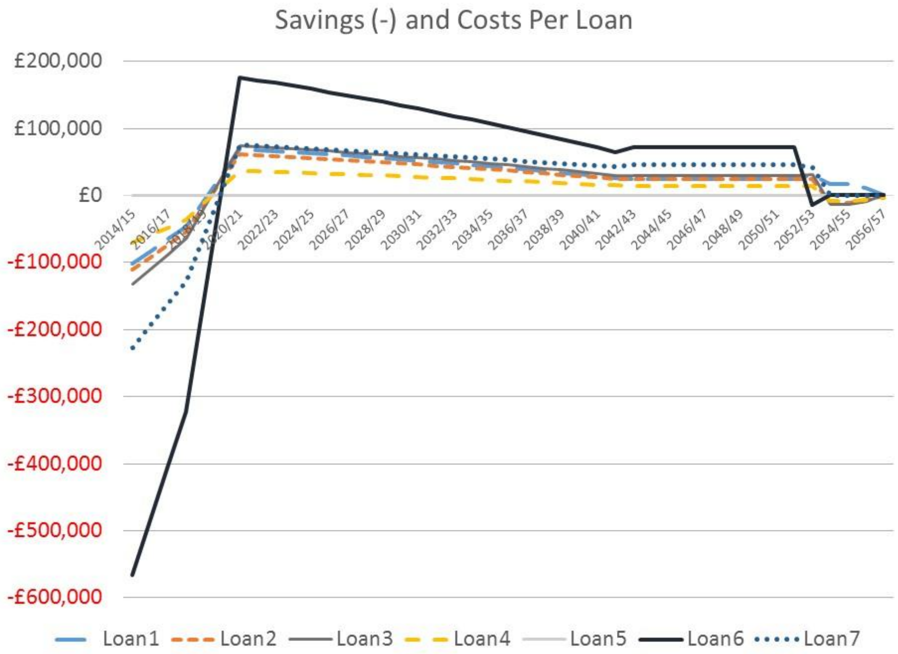


Early Repayment of Debt

Officers continue to monitor potential saving opportunities associated with the early repayment of existing debt. This takes into account the premiums or discounts associated with early repayment and the projected cost of refinancing or loss in investment interest.

To demonstrate the current position, the graph below uses the early repayment rates provided by the PWLB as at 30 June and the latest interest rate forecasts, as provided by Capita Assets Services. This shows that whilst initial savings may be generated in the early years, in the longer term, any early repayment at this stage would ultimately cost more money if interest rate forecasts remain correct. The net cost per loan is shown to the left of the graph. This excludes the HRA self-financing loan of £30M as this was taken out at a preferential rate of 3.03% and is being repaid on the basis of equal instalments of principal and interest.

	Principal Outstanding	Net Cost
Loan 1	£4,000,000	£1,138,834
Loan 2	£4,000,000	£883,284
Loan 3	£4,800,000	£1,095,751
Loan 4	£2,500,000	£502,197
Loan 5	£15,079	£1,493
Loan 6	£17,000,000	£1,508,119
Loan 7	£6,900,000	£1,051,306



6. Investing Activities

As laid down in the approved Investment Strategy, the aim is to prioritise security and liquidity of the Council's investments. This is to ensure that the Council has sufficient cash to support its business, but also to minimise any further chance of a counterparty failing and the Council not being able to remove any cash deposited.

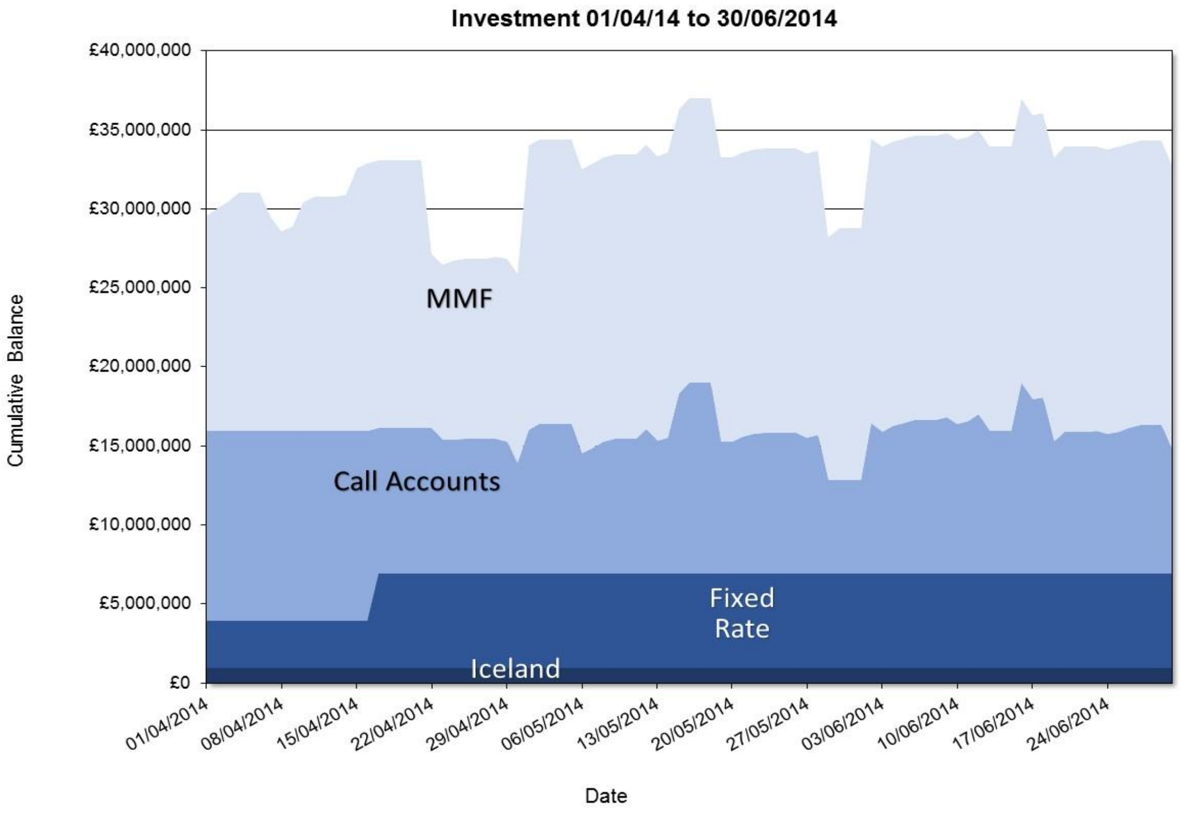
All investment activity has been in line with the approved Treasury Strategy for 2014/15. A full list of the investments at the end of Qtr 1 is shown below (Table 6.1):

Table 6.1 Counterparty balances

Other Investments	Opening £	Min £	Max £	Closing £	Indicative rate	Cumulative Interest £
Call: RBS	0	0	11,000	0	0.25%	0
Call: Lancashire County Council	12,000,000	0	12,000,000	2,024,000	0.25%	3,456
Call: Svenska Handelsbanken	0	0	5,864,000	5,864,000	0.40%	3,970
DMADF	0	0	0	0	0.25%	0
Government Liquidity MMF	1,634,000	0	6,000,000	6,000,000	0.25%	2,882
Liquidity First MMF.	6,000,000	6,000,000	6,000,000	6,000,000	0.39%	5,769
Insight MMF	6,000,000	5,071,000	6,000,000	6,000,000	0.35%	5,114
Lloyds	3,000,000	3,000,000	6,000,000	6,000,000	0.60%	8,186
Sub-total	25,634,000			25,888,000		29,377

Below is a graph which displays the different investment products used by the Council. The majority of the Council's balances are held within instant access MMF's or call accounts. This is partly because there are prudential controls that ensure a certain percentage is immediately available and also there is only a small pool of counterparties that meet the Council's credit criteria for fixed term deposits. Other UK banks, that meet the criteria such as HSBC, require much larger investment and market themselves at much larger institutional investors or corporations.

Graph 6.1 Investment balances



During the first quarter of 2014/15, the Council experienced a dramatic fall in the investment returns received from Lancashire County Council following a drop from 0.50% to 0.25% in the rate being offered. In addition, the interest rate associated with the newly opened account with Svenska Handelsbanken has also dropped by 0.10% to 0.40%.

However, two £3M fixed term investments have been placed with Lloyds Bank for a period of 3 months at a rate of 0.60%. The first matures on 09 July and the second on 17 July, and it is anticipated that these will be rolled on for a further 3 months upon maturity. Lloyds is still part nationalised and therefore continues to meet the criteria of 'Other Institutions' and the associated limits stated within the Treasury Management Strategy (reported to Council on 26th February 2014).

The newly opened account with Svenska Handelsbanken offers a dealing facility which is available until 3 pm, which is later than all other counterparties currently used. This enables the Council to sweep the cumulative balance held with The Cooperative Bank to ensure this balance is as close to zero by the end of the day.

Summary of Budget Position and Performance

In terms of performance against external benchmarks, the return on investments compared to the 7 day LIBID and bank rates over the year to date is as follows:

Base Rate	0.500%
7 day LIBID	0.475%
Lancaster City Council investments	0.427%

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

	Budget to Date £000's	Actuals to Date £000's	Variance £000's
Icelandic Credits	9	7	+2
Cash Interest	19	29	(10)
Total	**28**	**36**	**(10)**

The return is just below base rate and below the 7 day LIBID benchmark, this is mainly due to the Council's major investment counterparty (Lancashire County Council), halving their rate of interest. In absolute terms, the rate of return is very modest but given that the Council has continued to focus on secure and highly liquid deposits, it is considered reasonable.

Investment returns, excluding balances held in the Icelandic account, exceed the budgeted level. This is due to cash balances being larger than expected as a result of delays within the capital programme.

7. Risk management

There has been no material change in the policy or operation of the treasury function over the quarter, in recognition of the considerable uncertainty that exists within the economy and financial sector. The view is, therefore, that residual counterparty risk exposure for investment remains low.

The funds being held in Iceland still expose the Council to exchange rate risks, but these are unavoidable.

There is financial risk attached to the longer term debt portfolio, associated with interest rate exposure but all of the debt is on fixed interest and there has been no change to this over the quarter. Low investment returns mean that using cash invested to repay debt can appear more attractive, but the Council is not yet in a clear enough position to be following such a strategy.

Cash balances held with The Cooperative Bank continue to be monitored on a daily basis following the banks crisis in relation to its funding gap. The bank falls short of the council credit rating criteria and has not been on the approved lending list for some time.

8. Prudential Indicators

These indicators are prescribed by the Prudential Code to help demonstrate that the Council can finance its debt and have funds available when needed. The prudential indicators are listed in ***Annex B***.

9. Conclusion

The biggest impact on investment returns this quarter has been the fall in investment return offer by the Shared Investment Scheme managed by Lancashire County Council. The Council has a low risk profile, as 97% of balances are held in high quality products. Investment returns are expected to remain fairly static until the final quarter of this financial year.

Annex A

Treasury Management Glossary of Terms

- **Annuity** – method of repaying a loan where the payment amount remains uniform throughout the life of the loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.

- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.

- **Call account –** instant access deposit account.

- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.

- **Credit Rating –** is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's, and Moody's. They analyse credit worthiness under four headings:

    - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.

    - **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.

    - **Individual/Financial Strength Rating** – a measure of an institution's soundness on a stand-alone basis based on its structure, past performance and credit profile.

    - **Legal Support Rating** – a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

  The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO –** The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.

- **EIP –** Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal, therefore the interest due with each payment reduces as the principal is eroded, and so the total amount reduces with each instalment.

- **Gilts –** the name given to bonds issued by the U K Government. Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt.
  E.g. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45. The yield on that gilt is calculated as 8%/1.45 = 5.5%.
  See also PWLB.

- **LIBID** – The London Inter-Bank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time.

- **LIBOR –** The London Inter-Bank Offer Rate, the rate at which banks with surplus funds are offering to lend them to other banks, again published at 11am each day.

- **Liquidity –** Relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Maturity –** Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.

- **Money Market Fund (MMF) –** Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.

- **Policy and Strategy Documents –** documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.

- **Public Works Loans Board (PWLB)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.

- **Capita Asset Services** – are the City Council's Treasury Management advisors. They provide advice on borrowing strategy, investment strategy, and vetting of investment counterparties, in addition to ad hoc guidance throughout the year.

- **Yield** – see Gilts

Members may also wish to make reference to *The Councillor's Guide to Local Government Finance.*

Annex B

PRUDENTIAL INDICATORS - LANCASTER CITY COUNCIL

AFFORDABILITY

			£'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
PI 1:	Estimates of ratio of financing costs to net revenue stream	Non - HRA	12.8%	12.4%	12.5%	12.8%
		HRA	23.3%	22.5%	21.8%	20.9%
		Overall	17.1%	16.6%	16.3%	16.2%

PI 2:	Actual ratio of financing cost to net revenue stream	Reported after each financial year end

PI 3:	Estimates of the incremental impact of new Capital Investment decisions on the Council Tax	-£6.70	£11.27	£3.48	£0.97
	This includes the impact of all elements of funding, including any increase in the need to borrow, required to finance new schemes added to the Capital Programme	-3.4%	5.6%	1.7%	0.5%

		Repayment Period		
PI 3A:	Illustrative Impact of Additional Borrowing £1 million	**5 Years**	**10 Years**	**25 Years**
	Increase in Council Tax (£)	£4.86	£2.65	£1.47
	Increase in Council Tax (%)	2.48%	1.35%	0.99%

PI 4:	Estimates of the incremental impact of Capital Investment on Housing Rents	Nil	Nil	Nil	Nil

CAPITAL EXPENDITURE

PI 5:	Estimates of capital expenditure	Non - HRA	17.290	10.170	3.910	4.030
		HRA	4.870	4.790	4.930	4.660
		Total	22.160	14.960	8.840	8.690

PI 6:	Actual capital expenditure	Reported after each financial year end

PI 7:	Estimates of Capital Financing Requirement	Non - HRA	40,281	45,101	45,651	46,547
		HRA	44,473	43,432	42,391	41,350
		Total	84,754	88,533	88,042	87,897

PI 8:	Actual Capital Financing Requirement	Reported after each financial year end

EXTERNAL DEBT

PI 9:	Authorised Limit				
	Authorised Limit for Borrowing	101	101	104	104
	Authorised Limit for Other Long Term Liabilities	1	1	1	1
	Authorised Limit for External Debt	102	102	105	105

PI 10:	External Debt: Operational Boundary	85	88	88	88

PI 11:	Actual external debt	Reported after each financial year end

PI 12:	HRA limit on indebtedness	60,194	60,194	60,194	60,194

PRUDENCE

PI 13:	Treasury Management: adoption of CIPFA code of Practice	The Council has adopted the updated Treasury Management code of practice (2011).

PI 14:	Net debt and the capital financing requirement				
	Anticipated indebtedness (operational boundary)	84,531	88,310	88,310	87,819
	Anticipated investment	10,301	18,210	18,900	19,960
	CFR	84,754	88,533	88,042	87,897
	Under/over borrowed (-/+)	-10,078	-17,987	-19,168	-19,882