CABINET

Annual Treasury Management Report 2009/10
27 July 2010

Report of Head of Financial Services

PURPOSE OF REPORT					
This report sets out the performance of the Council in respect of Treasury Management for 2009/10 and gives details of the activities undertaken during the year.					
Key Decision		**Non-Key Decision**		**Referral from Statutory Officer**	**X**
This report is public.					

RECOMMENDATIONS OF COUNCILLOR LANGHORN:

That the report be noted and referred on to Council for information.

1 **Introduction**

1.1 The Council's Treasury Management Strategy for 2009/10 was approved by Council on 4th March 2009. This report sets out the related performance of the treasury function by providing details of:

a) long term and short term borrowing (i.e. debt that the Council *owes*)
b) investment activities
c) relevant borrowing limits and prudential indicators.

It is a requirement of the CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice on Treasury Management in Local Authorities that such a report be made to the Cabinet within six months of the end of the financial year, and that it also be reported to Council for information.

1.2 The aim of the Treasury Management Policy and associated activity is to ensure that the investment of surplus cash is managed in line the guidance issued by both CIPFA and Government, as well as in line with the Council's appetite for risk. For 2009/10 the appetite for risk was understandably low following the collapse of the Icelandic banks and resulting volatility in the wider economy.

1.3 Treasury management is a technical area. Training has been provided in the past to Members and this continues to be an important part of the updated CIPFA code of practice (November 2009) covering strategies from 2010/11 onwards. To assist with the understanding of this report, a glossary of terms commonly used in Treasury Management is attached at ***Appendix A***. In addition, the Councillor's Guide to Local Government Finance also has a section on treasury and cash management, and this is available through the Member Information section on the Intranet.

2 Summary: Headline Messages for 2009/10

2.1 The key points arising from this report are as follows:

- At the start of the year, the Council had £6M of investments at risk, tied up with the collapse of the Icelandic banking sector. CIPFA issued a further bulletin to inform closure of the 2009/10 final accounts giving the latest position in terms of expected recovery. Based on this and the Council's own responsibility for setting aside prudent provision, a further impairment of £1,249K has been put through the accounts, on top of that calculated in 2008/09. This increase in impairment is due to the challenge by Glitnir over the preferential creditor status of local authority deposits. Whilst CIPFA has stated that its current expectation (based on legal advice obtained by local authorities and on other advice) is that this will be resolved in favour of local authorities, given the uncertainties and potential impact, the impairment adjustment is based on a 50/50 chance of being classified as a preferential creditor of both Landsbanki and Glitnir. A further reserve has also been set aside of £1,363K, this being the difference between the worst case scenario and the cumulative net impairment put through the accounts in 2009/10.

- In addition, Government granted the Council a capitalisation order allowing £2.1M of the impairment to be treated as capital rather than revenue. This has been utilised in full to defer the impact on revenue/council tax.

- No new long term debt has been taken on in the year. The Council has not breached any Treasury Management Prudential Indicators relating to debt in the year. Borrowings were in line with the Council's Capital Financing Requirement (CFR), they have not been above either the Operational or Authorised limits and the maturity profile/variable rate exposure on borrowings has also stayed within the approved limits.

- No long term loans have been repaid in the year. A small amount of temporary borrowing was taken out at the start of the year to support day to day cash flow; all of these were repaid by the end of quarter 1.

- The Council has stayed within its Prudential limits for investments and has not breached any of the criteria set out in the approved strategy. Funds have been kept either on instant access or within short fixed term deposits at the Debt Management Office (part of Her Majesty's Treasury).

- Outturn on investment interest was £108K, which was £22K above budget (after removing notional interest on Icelandic deposits). This is due to increased cash balances compared to prior years, albeit at much lower yields. Last year had a far smaller capital programme than in prior periods and in addition there has been a recovery in the cash position since the repayment of £5.6M of PWLB loans in the final quarter of 2008/09.

3 Icelandic Investments

There is still significant uncertainty over the position on the Council's Icelandic investments. This is mainly due to the challenge by Glitnir over the status of the Council's creditor status. This is significant because creditor status has a large impact on the rate of return; e.g. 29% recovery instead of 100%, in the case of Glitnir. On a £3M investment, in simple cash terms (not taking into account the effect of timing of repayments) this equates to a difference of £2.13M between the best and worst cases. Although Landsbanki have currently classified local authorities as preferential creditors, it is expected that should Glitnir's challenge be successful, status for Landsbanki would be changed accordingly.

CIPFA has recently issued accounting that gives details of possible range in relation to the rates of return and their timings. These have been used as the basis for the year end entries in the 2008/9 accounts and are summarised below:

<u>KSF (Kaupthing, Singer & Friedlander)</u>

The administrators issued the latest creditors report in April 2010. This report noted that the current estimated total distributions to unsecured creditors should be in the range of 65p to 78p in the pound with the total dividends paid to date coming to 35% of the claim.

The Council has therefore made the assumption that the total return will be 71% with the remaining 36% being spread between July 2010 and January 2013.

<u>Glitnir</u>

Under the best case scenario, if local authority deposits retain priority status, 100% of claims are expected to be repaid. No payment is expected to be received prior to the court cases required to make the decision on creditor status and any appeal in respect of priority status being heard. It is therefore estimated that the earliest date by which payment could be made is the end of June 2011.

Under the worst case scenario where local authority deposits with Glitnir do not enjoy preferential status, the expected recovery rate is 29% with the remaining amounts assumed to be recovered evenly between October 2011 and October 2015.

In calculating the impairment the Council has assumed a 50:50 chance of being classified as a preferential creditor and so has assumed a 65% recovery.

<u>Landsbanki</u>

Under the best case scenario where local authority deposits maintain priority status, the expected recovery is 95% with annual instalments until October 2018. Under the worst case scenario, the recovery rate is 38%, again, with annual instalments until October 2018.

In calculating the impairment the Council has assumed a 50:50 chance of being classified as a preferential creditor and so has assumed a 67% recovery.

<u>General comments</u>

The claims with Glitnir and Landsbanki were converted to Icelandic Krona (ISK) on 22 April 2009. The exchange rate at this date was 190.62 ISK per £. Repayments by the banks will be based on the value of the deposit in ISK so the sterling value received by authorities will depend on the prevailing exchange rate which may be lower than the equivalent value on 22 April 2009 (the rate as at 31/3/2010 was 194.7 ISK per £).

However this is offset because most of the banks' assets are in currencies other than ISK so the amount of ISK that the banks will recover from their creditors will also vary with exchange rate movements. As reported by CIPFA, an analysis of movements to date indicates that the two risks are reasonably equally balanced, and any net increase or decrease in the amount of repayments received by authorities is not expected to be material, although it is possible this could change in the future. As such, exchange rate risk has been ignored when calculating the likely returns.

Using this information, the Council has "impaired" its Icelandic assets by a further £1.249M on top of the £1.632M recognised (but deferred) in 2008/09. Accounting guidance allows the netting off of notional interest that the investments are 'earning' whilst still on the Council's balance sheet and taking this into account, the net impairment charged to the accounts in 2009/10 was £2,189K. DCLG allocated a £2.1M capitalisation order to the Council, all of which has been used. This means that this revenue charge can be treated as capital and so spread over 20 years, lessening the acute impact on council tax.

In addition, given the impact of the preferential creditor decision, a further amount has been set aside in a reserve, equal to the difference between the 50/50 estimate and worst case scenario, this being a further £1,363K.

4 Borrowing

4.1 Longer Term Borrowing and Funding of Capital.

Long term borrowing is an important part of the Council's capital financing. Under the Prudential Code a key indicator is the Capital Financing Requirement (CFR). This figure is calculated from the Council's balance sheet and represents, in broad terms, the gap between the value of fixed assets and that of capital reserves. In essence, this gap may be viewed as the cumulative amount of capital investment that may need to be funded through external borrowing (i.e. the amount of capital investment that hasn't been funded from other sources). Borrowing should not then exceed the CFR on a long term basis, as this would indicate that borrowing is being used to fund expenditure other than capital. For 2009/10 the figures were as follows:

	£000
Opening CFR	45,857
Closing CFR	46,376
Average CFR	**46,117**
Weighted average borrowings	39,501
Weighted average investments	18,231
Net borrowings	**21,270**

From this it is clear that net borrowings are well below the Council's CFR, and average gross borrowings are comfortably below. This supports the reported position, i.e. that long term borrowing has not been used to fund revenue activities.

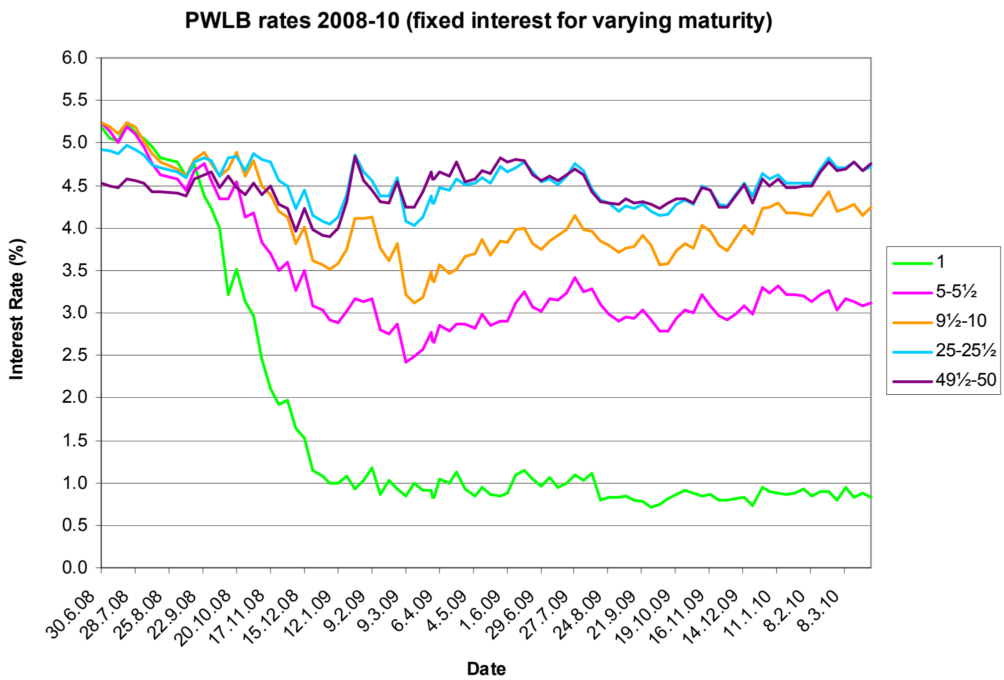
In addition, other indicators are set to control the absolute amount of debt (the Authorised limit) and expected gross debt but allowing for day to day cash management (Operational Boundary).

	Actual Debt 31/3/2010	Operational Boundary	Authorised Limit
	£000's	**£000's**	**£000's**
Deferred Liabilities	223	-	290
PWLB Debt	39,215	-	57,710
Total	39,438	56,000	58,000

It can be seen that the Council was £18,562K below the Authorised Limit and also £16,562K below the Operation Boundary. The debt boundaries appear high in relation to the level of debt actually incurred, but these were originally set to provide flexibility for some potentially large liabilities within the capital programme arising in connection with matters such as the planned sale of land at South Lancaster and the claims against the Council in relation to Luneside East land acquisitions. These have not resulted in a direct impact on capital expenditure or income in 2009/10, but the flexibility has been rolled forward into the debt limits set within the 2010/11 strategy.

4.2 PWLB Interest Rate Movements

All of the Council's long term borrowings are held with the Public Works Loan Board (PWLB). During the course of 2009/10 the spread in rates which started in 2008/09 has remained, with a much lower rate for short term loans than those for longer periods. Long term loans of 25 years or more have remained at around 4.5% whereas short term rates for loans of 1 year have remained at around 1%; this latter is a historically low rate reflecting the wider state of the economy.



Repayment of PWLB debt is an attractive option in the current climate, this is because investment returns are far lower than the interest payable on existing debt. However, early repayment of PWLB debt may be subject to additional charges (known as premiums), if the loans to be repaid are at higher rates than the prevailing rates of interest at the point of repayment. In essence the premiums compensate the PWLB for lost interest. As the rates for new loans were below the rates of the Council's existing loans, no further repayments could be made without incurring significant penalties during 2009/10.

4.3 **Debt Maturity (or Repayment) Profile**

The Council is exposed to "liquidity" risks if high value loans mature (i.e. become due for repayment) at the same time, making a large demand on cash. One Prudential Indicator which is used to manage this risk is the maturity structure of borrowing. This indicator introduces limits to help reduce the Council's exposure to large fixed rate sums falling due for repayment (and potentially re-financing) all at once. The table below shows these profiles at the beginning, middle and end of the year against the indicator.

None of the Council's current longer term borrowing is due for scheduled repayment in the next ten years although, as discussed above, further early repayments could be made, depending on circumstances.

	Prudential Indicator	**Actual 31/3/09**	**Actual 31/9/09**	**Actual 31/3/10**
Under 12 months	0-35 %	18%	0%	0%
12 – 24 Months	0 - 5%	0%	0%	0%
24 – 5 years	0 – 10%	0%	0%	0%
5 – 10 years	0 – 20%	0%	0%	0%
10 years above	60 – 100%	82%	100%	100%

4.4 **Interest Payable on Longer Term Borrowing**

The average rate of interest payable on PWLB debt in 2009/10 was 5.68% (2008/09 5.56%) with the increase being due to repayment of some of the cheaper loans in 2008-09. However, the cost of long term borrowing was exactly on budget.

	£'000
2009/10 Estimate	2,227
2009/10 Actual	2,227 (of which £799K was charged to the HRA)
Variance	0

As investment rates are not expected to improve markedly over the next 12 months Officers will continue to look for opportunities to repay debt rather than invest surplus cash given that this will reduce the counterparty risk for the Council and investment returns are currently well below the interest charges on the debt.

Prudential Indicators also provide exposure limits that identify the maximum limit for variable / fixed interest rate exposure, based upon the debt position. The table below shows that the outturn position was within the limits set by Members at the beginning of the year. The Council currently only has fixed interest rate maturity debt, although again this could change in future if market conditions warrant or facilitate it.

	Prudential Indicator	Actual
	%	%
Fixed Rate	100	100
Variable Rate	30	0

As yet there is no information available for last year with which to compare performance with other local authorities.

5 **Shorter Term Borrowing (to support cash flow)**

During 2009/10 some short term borrowing was required to support the Council's cash position at the start of the year. This need was influenced by the decision to repay PWLB loans in the final quarter of 2008/09 and to cover £3M of Icelandic bank deposits that were due back in January 2009. These two events meant there was less cash than normal at the start of 2009/10. The total cost in year was £1.5K in interest paid.

6 **Investment Activities**

6.1 **Performance against Prudential Indicators**

In 2009/10 all investments were placed in accordance with the approved Investment Strategy; there have been no breaches of the investment criteria.

The Council has made no investments and held no investments with a maturity of longer than 365 days from the end of 2009/10; the investment strategy prohibited such long term investments. All deposits have been made either to instant access call accounts and money market funds or have been placed as term deposits with the Debt Management Office (DMO), part of Her Majesty's Treasury.

A full list of fixed investments is enclosed at ***Appendix B***.

6.2 **Performance against budget and external benchmarks.**

Interest earned in the year can be summarised as follows:

Interest earned	£108K (£32K of which was credited to the HRA)
Revised budget	£86K
Variance	£20K favourable

In addition, there was notional interest earned on Icelandic investments of £261K. This interest is derived from accounting standards and does not reflect interest actually payable to the Council on these investments. However, in line with proper accounting practice, whilst the Council has such investments on the balance sheet, interest must be credited into the General Fund revenue account. This then nets off in part the impairment of the assets. Given its nature, it is not included with the actual interest earned of £108K when reviewing performance for the year.

In terms of performance against external benchmarks, our investment returns can be summarised as follows:

Indicator (mean value)	**2008/09**	**2009/10**
Base Rate	3.61%	0.50%
3 Month LIBID	4.59%	0.83%
Lancaster CC investments*	3.91%	0.59%
Lancaster CC investment	5.82%	0.86%

*This rate includes £6M frozen in Icelandic banks, but assumes they are not generating any interest.

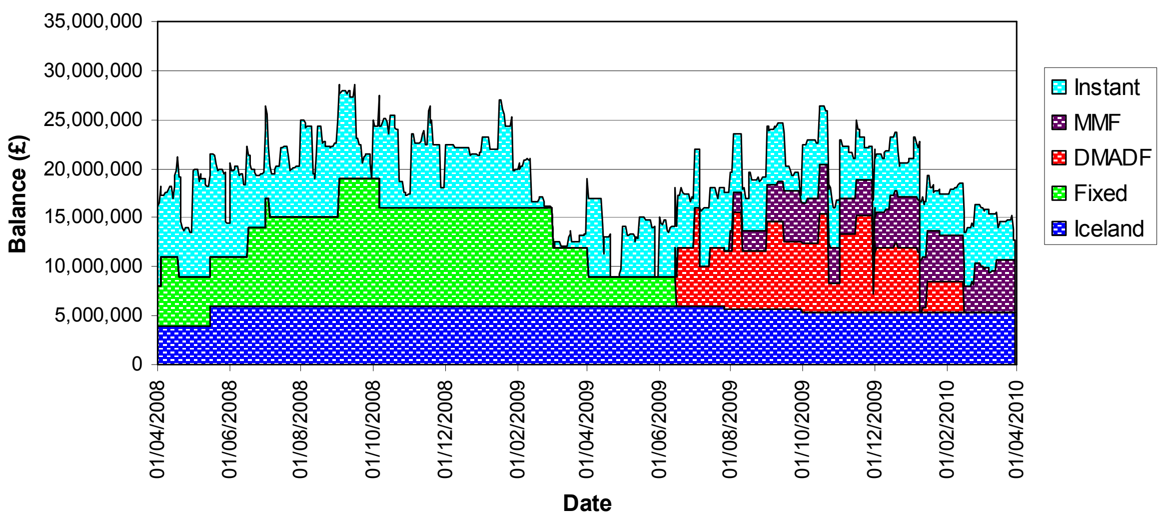
Overall, the investment returns (adjusted for Iceland) were within the range limited by the base rate and LIBID (London Inter-bank Bid) rate. In comparison to the prior year, there is a marked drop in the returns, which reflects the consolidation of the downturn which started in 2008/09. It is anticipated that returns will improve over the year but as can be seen from the table below, these predictions are cautious and do not represent a quick return to the high rates of investment interest being earned during 2007/08.

Date	3 month LIBID projection (%)
01/06/2010	0.50
01/09/2010	0.60
01/12/2010	0.80
01/03/2011	1.20
01/06/2011	1.40

Source: Butler's investment monitor, 21 June 2010

Following the Icelandic banking crisis, the approach to investments has changed markedly. The Investment Strategy for 2009/10 approved in March 2009 formalised a much more cautious approach to managing surplus cash. This restricted the term of deposits to 1 year, reduced the counterparty limits and removed the option to make non EU deposits. In practice, deposits were placed on instant access in either call accounts or Money Market Funds (MMFs), or were placed on term deposit in the DMO account. The pattern of these investments over 2009/10 and the prior year can be seen in more detail below (the reduction in Iceland balances represents the repayments made by KSF).

Investment values over the period (fixed vs instant access)



Similar to the borrowing comparators, there is currently no information available regarding other Local Authorities' investment performance during 2009/10.

7 Other Risk Management Issues

Many of the risks in relation to treasury management are managed through the setting and monitoring performance against the relevant Prudential Indicators and the approved investment strategy, as discussed above.

The risk management framework within treasury management has been recently updated within the new codes of practice from CIPFA and the new investment guidance due from the DCLG. Since 2007/08 the environment has changed from a relatively stable economy with investment returns that were higher than the cost of much of the Council's debt, to one where investment returns have slumped and the credit worthiness of counterparties is paramount. The Authority's Investment Strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and length of deposit to generate a pool of counterparties, together with consideration of non credit rating information to refine investment decisions. This strategy is required under the CIPFA Treasury Management Code, the adoption of which is another Prudential Indicator. Strategies for 2010/11 onwards comply with updated code of practice and investment guidance.

8 Other Prudential Indicators

As required under the Prudential Code, certain other year end Prudential Indicators must be calculated and these are included elsewhere on the agenda, as part of the 2009/10 Outturn report. These will be incorporated into the referral report to Council and cover the other side of investment and debt management referred to briefly in section 4.1 above, this being capital expenditure.

9 Details of Consultation

Officers have consulted regularly throughout the year with Butlers, the Council's Treasury Management consultants.

10 Options and Options Analysis (including risk assessment)

There are no options available to Members as such; reporting of activities to both Cabinet and Council is required under Treasury Management Code of Practice and reflected in the Council's Strategy.

11 Officer Preferred Option and Comments

Not applicable.

12 Conclusion

As for 2008/09, the main issue for 2009/10 treasury management performance relates to Icelandic investments. Given the amounts involved and the level of uncertainty, the outcome of the Glitnir challenge to the Council's creditor status will have a material impact on the authority's financial position. However, steps have been taken to set aside sufficient amounts to cover the worst case scenario.
Due to the impact of Iceland on the Council's risk appetite associated with investing surplus cash and the wider economic malaise, all other Treasury management activity has occurred within a very narrow band of low risk products and counterparties with a resultant drop in investment returns compared to prior years. The Council's appetite for risk will need to be reviewed regularly in future, to ensure it remains appropriate to future situations and circumstances.

RELATIONSHIP TO POLICY FRAMEWORK
This report is in accordance with the Council's Treasury Management Policy Statement.

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability, etc)
No direct implications.

FINANCIAL IMPLICATIONS
As set out in the report. These have also been incorporated into the outturn for 2009/10, as included elsewhere on the agenda.

DEPUTY SECTION 151 OFFICER'S COMMENTS
The Deputy Section 151 Officer has been consulted and has no comments to add.

LEGAL IMPLICATIONS
Legal Services have been consulted and have no comments to add.

MONITORING OFFICER'S COMMENTS
The Monitoring Officer has been consulted and has no comments to add.

BACKGROUND PAPERS **Treasury Management Strategy and Policy documents 2008/09.**	**Contact Officer: Pete Notley** **Telephone: 01524 582567** **E-mail: pnotley@lancaster.gov.uk**