PERFORMANCE REVIEW TEAM

2010/11 Treasury Management Progress Report to 30 June 2010

Report of Head of Financial Services

1. Introduction

It is a requirement of the CIPFA Code of Practice on Treasury Management (updated November 2009) 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.

Council approved the Treasury Strategy including the Investment strategy for 2010/11 at its meeting on 03 March 2010. This report outlines activities undertaken in pursuance of those strategies during the financial year.

2. Summary

- During the first quarter there has been no movement in terms of Icelandic investments (although since then, at the end of July, there has been a further repayment in respect of KSF). The Council's creditor status for Glitnir and Landsbanki is still being tested through the Icelandic courts and the outcome will have a material impact on the level of recoveries.

- Regarding investment interest to 30 June, income was £26K higher than budgeted and this trend should continue during the year.

- On other treasury matters there have been no changes to the debt portfolio. No temporary borrowing was required during the quarter, no new long term debt has been taken on and there has been no opportunity for repayment of existing loans.

- There have been no material breaches of any prudential indicators or counterparty limits in the quarter and no other major risks have been identified.

- A call account facility with Lancashire County Council has been opened and will be in operation from quarter 2 onwards. This will add a further highly liquid and secure counterparty to the council's approved list.

3. Icelandic Investments Update

Regarding Icelandic investments, there is little new information from that reported as part of the 2009/10 outturn. To 30 June total repayments of £716K had been received from KSF against the £2M original deposit, meaning that around £1.3M was still outstanding. (Since then, a further £205K has been received, bringing total recoveries to 45% and leaving around £1.1M outstanding on this investment.)

The legal action regarding preferential creditor status in relation to the Landsbanki and Glitnir investments (totalling £4M) is still underway in the Icelandic Courts. The Council continues as a party to the joint arrangements with other local authorities, organised through the Local Government Association and using Bevan Brittan, as this represents the most cost-effective way of taking legal action.

Further to making various provisions for potential losses within the 2009/10 draft accounts, there needs to be changes to the ongoing interest being accounted (and to be budgeted) for on Icelandic investments, which impacts on performance against the investment interest budget. This is discussed in more detail in section 6 below.

4. Debt Portfolio

There has been no change to the debt portfolio in the quarter and there is no immediate need to take out new long term loans. The Council's cash flow position remains strong, which 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). Officers continue to monitor PWLB repayment rates for opportunities to reduce the outstanding debt balance without incurring early repayment penalties; the current position is reviewed in detail in section 5 below.

In terms of expenditure, the capital programme for the next 5 years was approved by the Council on 3rd March 2010. There may be pressure to borrow at some point over the 5 year programme depending on the progress made on South Lancaster land sales, the ultimate settlement of Luneside East compensation claims and the demands of large Council-funded capital schemes, such as the municipal building works programme. Any proposals to update the capital programme and debt strategy will be brought forward if need be, as and when more details emerge on these issues.

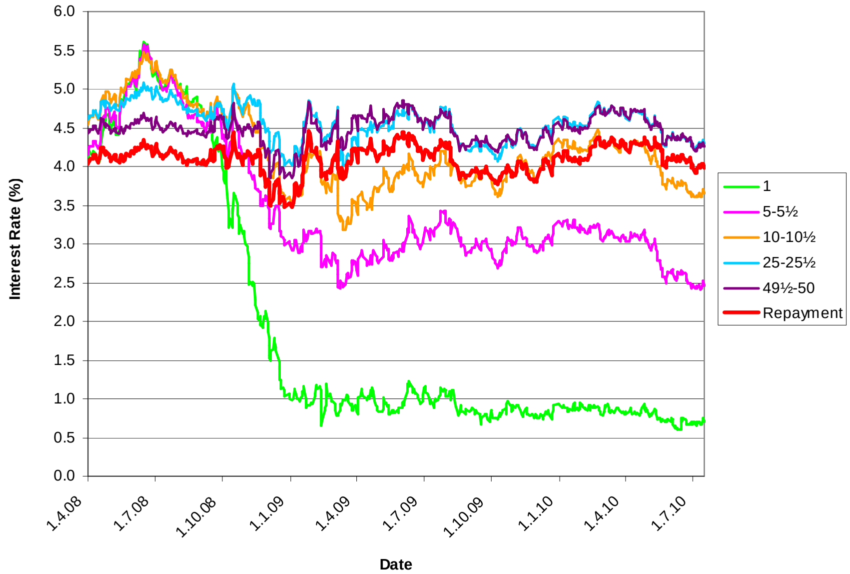
5. Current Borrowing Rates

The graph below shows that the pattern seen since January 2009 has persisted, with a marked spread between short term and long term borrowing. The first quarter of 2010/11 has seen a drop off in the rate for new longer term loans from around 4.6% to around 4.3% which although markedly more expensive than the short term loans, is still low relative to the Council's existing portfolio which has an average rate of 5.68%.

In addition, the rate for calculating repayment premia has also reduced which limits further the chance of early repayment opportunities. At the end of the quarter this was at around 4% in comparison to the Council's cheapest major loan which is at 4.6%; only when the repayment rate rises to 4.6% could we repay early without penalty.

Where possible early repayment is an attractive option as the interest payable on exiting loans far out weighs the interest earnable on surplus cash balances and it would also reduce the security risk associated with placing investments. Officers will continue to monitor the opportunities for early repayment through Quarter 2.

Historic PWLB rates (fixed interest for varying maturity)



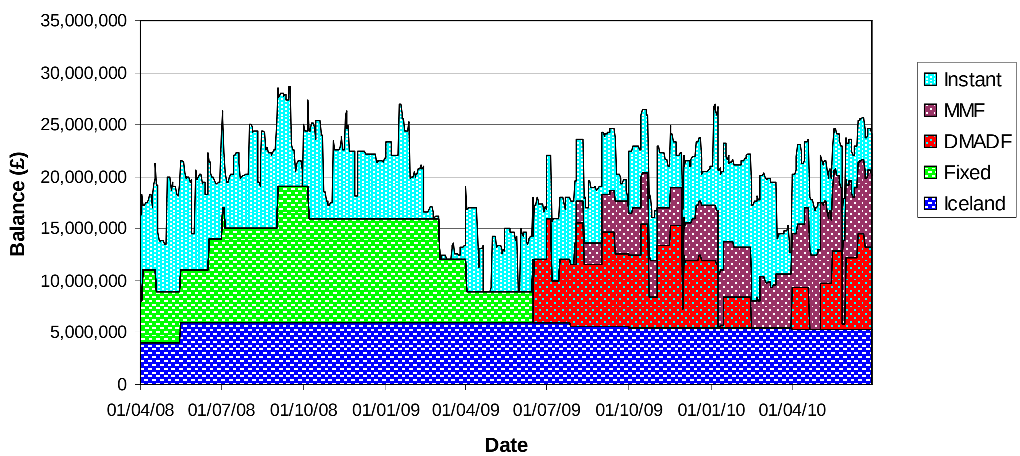
6. Investing Activities

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 its deposits, as happened with the Icelandic banks.

All investment activity has been in line with the approved Treasury Strategy for 2010/11. No fixed term investments have been placed since September 2008, with the exception of Debt Management Accounts Deposit Facility (DMADF) deposits (i.e. with HM Government). Any other surplus cash has been managed on a day to day basis using the call accounts and Money Market Funds (MMF). A full list of the investments at the end of quarter 1 is enclosed at ***Appendix B***.

The split of investments is shown graphically below (see also further details in ***Appendix B***). It is clear from this that the investment portfolio is split between Call accounts, the DMADF and MMFs. This keeps deposits secure, liquid and spread over a number of counterparties. As mentioned earlier, £716K has been repaid to 30 June by KSF, which has reduced the investment balance outstanding with Icelandic banks.

Investment values over the period (fixed vs instant access)



7. Summary of Budget Position and Performance

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	0.66%
Lancaster CC investments	0.43%

The return is below both base and 3 month LIBID as the Council has focussed on secure and highly liquid deposits. This has limited activity largely to the DMADF and the two MMFs, all of which have returns below base rate. In addition, the use of the Santander call account has been put on hold following concerns over the standing of the Spanish parent bank. Nearly 100 European banks, including Santander, are being subjected to stress testing by the Committee of European Banking Supervisors. Officers will review the position in relation to deposits with Santander following the conclusion of this review.

Separately, a new call account facility has been set up with the County Council. This has benefits in terms of diversifying the Council's portfolio whilst meeting the criteria of secure and liquid investments; the account also pays a competitive interest rate of base + 0.2%. The approved Investment Strategy also allows for fixed term deposits up to 1 year with other local authorities, which means that the Council could take advantage of the County Council's fixed term investment offer that would match the market rate. This would pay a significant margin over the instant access rates albeit at the expense of liquidity. Current market rates for a 12 month deposit are in the region of 1.6% (as per Butler's investment monitor 19th July 2010).

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

Annual budget	£148K	
Profiled budget	£37K	
Actual to date	£18K	(see details in ***Appendix B)***
"Icelandic" to date	£45K	(see details in ***Appendix B)***
Total	£63K	
Variance	£26K	(favourable)

The reason for the favourable position is due to the increased interest that now needs to be accounted for on Icelandic investments, following the Council making full provision for estimated losses (in both principal and interest terms). Since the budgets were set expectations about recovery of Icelandic investments have been revised; it is now expected to take significantly longer than was thought at the end of 2009, which means that these investments will be on the Council's balance sheet for longer, which in turn means more interest to be accounted for, over longer periods.

Once the 2009/10 accounts have been audited, officers will be in a good position to re-estimate the Icelandic interest credits for 2010/11 and beyond, for building into the budget process.

In terms of the legal costs associated with Icelandic investments, for 2009/10 these were in the region of £5K and it is estimated that a similar level of cost will be incurred through 2010/11. The joint arrangements organised through the LGA have resulted in the costs being very low, in comparison to what there would have been had the Council commissioned such support separately.

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 MMFs whilst avoiding any new fixed term investments except for short term deposits with the DMADF. The view is, therefore, that associated risks have remained consistently very low over the quarter.

There is also a liquidity risk associated with needing access to cash on a day to day basis. At the end of the period the Council had cash balances (excluding Iceland) of £18.8M, £10.8M of which was held on instant access. As such, liquidity is not judged to have been a significant risk during the quarter.

Aside from the above, there is also financial risk attached to the longer term debt portfolio, associated with interest rate exposure. Currently the Council is paying higher rates of interest on existing loans than it would be if new equivalent loans could be taken out. However, as discussed in section 5 above, until PWLB repayment rates improve, there will be no opportunities to restructure or repay loans without incurring significant penalties.

In addition, due to the unknowns linked to the capital programme, there is a risk that the Council may have to take on further borrowing. However, with rates at very low levels, particularly on shorter term loans, this is a relatively good period to take on new borrowings if so required. The relatively strong cash position means though that this is quite unlikely, with the preferred option being to fund any capital requirement internally and reduce investment balances.

Finally, with regard to recovery of Icelandic investments, this is still being managed with legal support organised through the Local Government Association. It is judged that this is the most effective way of maximising recovery on the Council's behalf. Provision was made in 2009/10 accounts to set aside resources to cover the worst case scenario on Icelandic banks as well as capitalising £2.1M of the impairment under a capitalisation directive. These actions serve to protect the Council against financial risks associated with uncertain recovery as well as smoothing the impact on Council Tax. Future views on recovery prospects will be informed by accounting guidance and information arising from the legal proceedings.

9. Conclusion

Consistent with the prior year, the first quarter of the 2010/11 has been steady in treasury management terms.

The appetite for risk has remained very low with the use of either AAA rated MMFs, instant access call accounts or deposits with HM Treasury. There are now options to improve returns slightly whilst remaining within the approved Investment Strategy and keeping appetite for risk still at low levels, through the placing fixed term deposits with the County Council, as an example. These will be pursued over the next quarter, and any actions will also be informed by the results of the stress testing on European banks.

Whilst some progress has been made in recovering Icelandic investments, the bulk of monies outstanding are still subject to court action with no new significant information as yet in terms of a likely outcome.

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