

Annual Treasury Management Report 2010/11

For consideration by Cabinet 26 July 2011

1 Introduction

1.1 The Council's Treasury Management Strategy for 2010/11 was approved by Council on 03 March 2010. 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 2010/11 the appetite for risk remained 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 **Annex 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. Member training has been organised with the Council's Treasury Management consultants, Sector, for later in the 2011/12 financial year.

2 Summary: Headline Messages for 2010/11

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

- There is still a great deal of uncertainty in the economy with a number of competing factors in the balance as to whether interest rates may increase and the timing of any increase. Credit worthiness is still an key issue.
- Although there is reason for optimism in relation to Icelandic investments, the judgement to award preferential creditor status for Glitnir and Landsbanki has yet to be passed irrefutably. However, a concrete decision should be known before the end of the calendar year.
- Payments have continued against the KSF deposit which is now up to 53% repayment against a total predicted settlement of 82%.
- No new long term debt has been taken on in the year. The Council has not breached any Treasury Management 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, although the change to IFRS accounting has brought some very long term liabilities onto the Council's balance sheet, and these are longer than the range previously used in the maturity of debt indicator.

- Although the capital programme increased the amount of prudentially funded expenditure in year, this was offset by provision for repayment of principal so that the net underlying need to borrow was static in year.
- No long term loans have been repaid in the year and no temporary borrowings have been required to support day to day cash flow. The portfolio will monitored going forward with an eye on the potential requirement to finance a buy out of the HRA subsidy system.
- The Council has stayed within its Prudential limits for investments and has not breached any of the criteria set out in the approved strategy. As was the case in 2009/10, 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 £271K, which was £17K above the revised budget. This is largely due to higher cash balances in the year than anticipated and slightly higher rates of return on the call accounts and money market funds.

3 **Economic background**

2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, particularly in the peripheral Euro zone countries.

UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term. The Japanese disasters in March and the crisis in Libya caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

The cost of the UK Government's borrowing (Gilt yields) fell for much of the first half of the year as financial markets drew considerable reassurance from the Government's debt reduction plans, especially in the light of Euro zone sovereign debt concerns. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected to cause the Monetary Policy Committee (MPC) to start raising the Bank Rate. Although this did not happen in 2010/11, it remains a continuing pressure on the MPC. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation.

The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May 2010), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package.

Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were highly sceptical as to the robustness of the tests, as they also are over the further tests now taking place. Results for these are due in mid-2011.

Overall then, there is still a great deal of uncertainty in the economy with interest rates still at historically low levels. There are a number of competing factors in the balance as to whether rates may increase and if so, what the timing of any increase might be. Credit worthiness is still an key issue.

4 Icelandic Investments

There is still significant uncertainty over the position on the Council's Icelandic investments. Although the Council has had a favourable verdict on its creditor status for both Landsbanki and Glitnir, these rulings have been appealed and so, as yet, there is no definitive outcome. The high court ruling is expected some time in late Summer or Autumn 2011 which may, or may not, be in time for the final accounts being signed off.

Although CIPFA revised its accounting guidance, removing the worst case scenario from its recommended range of values, the Council has not adjusted the impairment on these investments, keeping them at a value that was half way between best and worst case. This is because revising the value upwards in line with CIPFAs recommended values would expose the Council to a potentially large revenue cost if the appeal led to the Council losing its preferential creditor status.

KSF are still making repayments and as at the end of the year, 53% of the claim (£1,082K including £22K of interest) had been paid. The latest prediction as per CIPFA (update 4) is that in total 82% of the claim should be refunded to the Council (£1,640K of principal and £39K of interest), which is an increase on the prior year.

As was reported in the prior year, there is an exchange rate risk linked to the Icelandic deposits. The claims with Glitnir and Landsbanki were converted to Icelandic Krona (ISK) on 22 April 2009. 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 (190.62 ISK/£, the rate as at 31/3/2011 was 183.4 ISK/£). However, as previously reported by CIPFA, this is not expected to be material, although it is possible that this could change in the future.

The Government allocated a £2.1M capitalisation order to the Council, all of which was used in 2009/10. Due to the upwards re-measurement of the KSF investment, £222K of the capitalisation has been reversed but the remainder is in place covering the recognised impairment on Glitnir and Landsbanki. Once a conclusive valuation for these two assets is available, the impairment and its financing will be reviewed.

5 **Borrowing and capital expenditure.**

5.1 **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 such as grants, revenue contributions and capital receipts). 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 2010/11 the figures were as follows:

	£000
Opening CFR	50,811
Closing CFR	50,820
Average CFR	50,816
Weighted average borrowings	39,215
Weighted average finance lease liability	4,187
Weighted average investments*	18,805
Net borrowings	24,597

From this it is clear that net borrowings are well below the Council's CFR, and average gross borrowings are comfortably below, even adjusting the CFR down for the balance sheet adjustments relating to finance lease liabilities. This shows that that long term borrowing has not been used to fund revenue activities.

In terms of capital expenditure and funding in the year, this can be summarised as follows:

	2009/10 (restated)	2010/11
	£000	£000
Opening Capital Financing Requirement	50,398	50,810
<i>Capital investment</i>		
Property, Plant and Equipment	9,066	8,397
Investment Properties	39	12
Intangible Assets	27	90
Revenue Expenditure Funded from Capital Under Statute	4,228	2,197
<i>Sources of financing</i>		
Capital receipts	(1,409)	(718)
Government Grants and other contributions	(5,660)	(3,258)
Direct revenue contributions	(1,499)	(1,823)
Minimum Revenue Provision	(2,076)	(2,121)
Major Repairs Reserve	(2,304)	(2,767)
Closing Capital Financing Requirement	50,810	50,819

This shows little movement in the CFR over the year. The capital programme was budgeted to have a borrowing requirement of £1.1M for 2010/11. The actual out-turn was £2.13M of prudentially funded expenditure. This increase was due to the decision to acquire vehicles and waste receptacles through capital expenditure rather than through sale and lease back agreements, on value for money grounds. Under the newly introduced international financial reporting standards (IFRS) many of these sale and lease back arrangements end up counting towards the Council's capital expenditure anyway, so future capital budgets will need to be adjusted to reflect this change in treatment and the impact on the CFR. This also explains why the 2009/10 figures have been restated as lease arrangements that were previously treated as revenue costs have been capitalised under IFRS accounting.

Although there was an increase to the Council's prudentially funded capital expenditure, this was offset by the reduction in capitalisation directive required for the impairment on the Council's investment with the Icelandic bank KSF (£222K) and through the statutory provision for repayment of principal (MRP). In summary, there has been little change in the underlying need to borrow, over the year.

To control the actual level of borrowing indicators are set on both the absolute allowable amount of debt (the Authorised limit) and expected gross debt allowing for day to day cash management (Operational Boundary). This is summarised below:

	Actual Debt 31/03/11	Operational Boundary	Authorised Limit
	£000's	£000's	£000's
Deferred Liabilities	223		
Long term Finance lease liability	3,433		
PWLB Debt	39,215		
Total	42,871	48,100	53,110

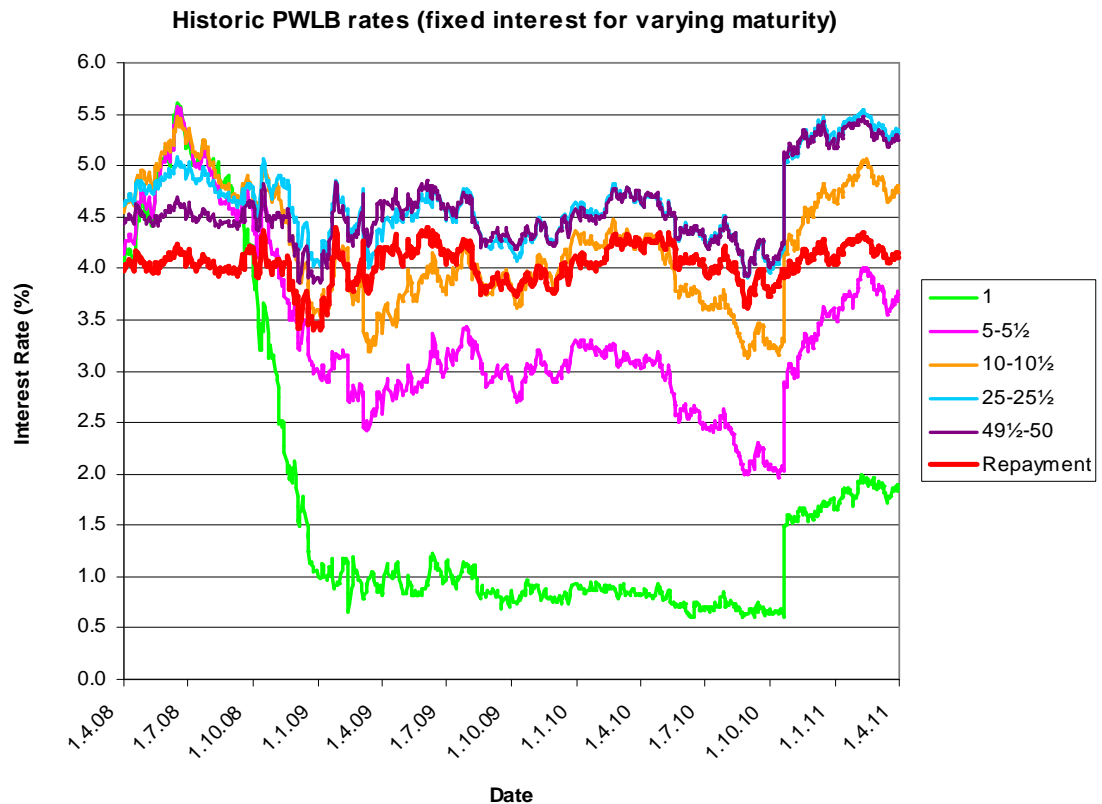
It can be seen that the Council was well below the Authorised Limit and Operation Boundary throughout the year. The debt boundaries appear high in relation to the level of debt actually incurred, but these were originally set to provide flexibility for some potentially large liabilities within the capital programme arising in connection

with matters such as Luneside East land acquisitions. These have not resulted in a direct impact on capital expenditure or income in 2010/11 and following the successful result in the first round of the Lands Tribunal, a smaller contingency is required in future years. However, other issues such the timing and likelihood of some major capital receipts still mean that flexibility is required in terms of future years' borrowing limits.

The Council's debt figure also includes the long term element of finance lease liabilities, in line with the Prudential Code. Although these are not strictly borrowings, they are included to reflect the capital substance of some lease contracts.

5.2 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 2010/11 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. The Government did however raise rates in October 2010, adding 1% across the board on PWLB rates:



Repayment of PWLB debt is still an attractive option in the current climate, as investment returns remain far lower than the interest payable on existing debt. However, the rates during 2010/11 did not allow this without inhibitive early repayment penalties. Opportunities to make repayments will be reviewed throughout 2011/12 although this will be done with an eye on the possible need to take on more debt should HRA self financing become a reality. In this case it may make sense to keep hold of existing loans if these are below the projected market rates.

5.3 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 Treasury 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 and end of the year against the indicator. The portfolio has not moved during the year.

None of the Council’s current longer term borrowing is due for scheduled repayment in the next ten years, although, as noted above, there may be some large changes to the debt portfolio going forward, in relation to HRA self financing.

	Treasury Indicator	Actual (restated) 31/3/10	Actual 31/3/11
Under 12 months	0-35 %	1%	1%
12 – 24 Months	0 – 20%	1%	1%
24 – 5 years	0 – 20%	1%	2%
5 – 10 years	0 – 20%	0%	0%
10 -15 years	0 – 50%	0%	0%
15 – 25 years	0 - 100%	0%	0%
25 – 50 years	50 – 100%	92%	91%
50 years and upwards		5%	5%

In line with the Prudential Code, these figures now include the finance lease liabilities brought onto the balance sheet under IFRS during 2010/11. As one of these leases is for longer than 50 years (Lancaster Market), the accounting adjustments result in a long term liability greater than 50 years in length which is outside the range of the indicators set for 2010/11. This is not judged to alter the liquidity risk of the debt portfolio which is otherwise well within the approved limits.

5.4 Interest Payable on Longer Term Borrowing

The average rate of interest payable on PWLB debt in 2010/11 was 5.68% which is identical to 2009/10 and was on budget.

	£'000
2010/11 Estimate	2,227
2010/11 Actual	2,227 (of which £724K was re-charged to the HRA)
Variance	0

There was also £429K of interest in relation to finance leases under IFRS accounting. This is a cost that in previous years has been presented within service expenditure. It is purely a presentational change with no impact on the bottom line.

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

Accounting for finance leases has not altered this as the interest rates implicit in the leases are fixed at their inception date.

6 Investment Activities

5.1 Performance against Prudential Indicators

In 2010/11 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 2010/11; 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.

Details of deposits are included in **Annex B**.

5.2 Performance against budget and external benchmarks.

In terms of performance against external benchmarks, the return on investments (not including notional Icelandic interest) compared to the LIBID and bank rates over the year to date is as follows:

Indicator (mean value)	2009/10	2010/11
Base Rate	0.50%	0.50%
3 Month LIBID	0.83%	0.74%
Lancaster CC investment	0.86%	0.53%

The return is just above base but well below 3 month LIBID. This is because the Council has focussed on secure and highly liquid deposits which have mainly been on instant access, hence the relatively poor rate of return.

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

Annual budget	£254K
Actual to date	£99K (see details in Annex B)
"Icelandic" to date	£172K (see details in Annex B)
Total	£271K
Variance	£17K favourable

There is a £17K favourable variance. This is largely due to higher cash balances in the year than anticipated and slightly higher rates of return on the call accounts and money market funds. The Icelandic income is a real credit to the general fund, unlike in previous years when this 'accounting' interest had to be reversed out to the

Financial Instrument Adjustment Account to net off against the deferred impairment charge.

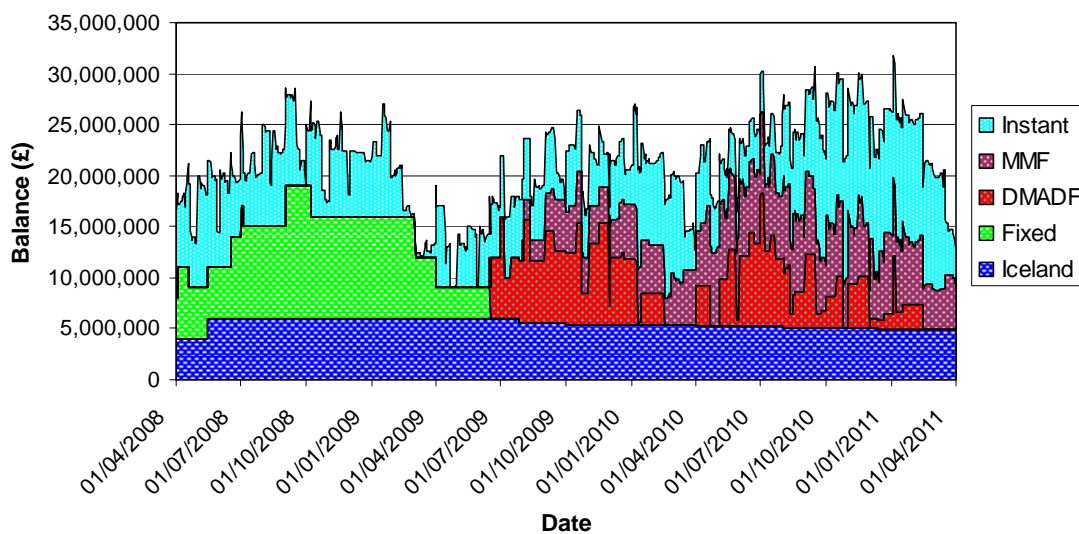
Overall, the investment returns were within the range limited by the base rate and LIBID (London Inter-bank Bid) rate. In comparison to the prior year, the overall rate of return is worse although the absolute amount of 'real' interest (not including Iceland) is similarly low (£99K vs £108K), which reflects the consolidation of the downturn which started in 2008/09. It is anticipated that returns may double over the year but as can be seen from the table below, these predictions are still cautious and are well below the high rates of investment interest being earned during 2007/08.

Date	3 month LIBID projection (%)
01/06/2011	0.80
01/09/2011	0.90
01/12/2011	1.25
01/03/2012	1.50
01/06/2012	1.75

Source: Sector, June 2011

The Investment Strategy for 2010/11 continued with the more cautious approach to managing surplus cash which has been in place since the banking crisis. This has restricted the term of deposits to a maximum of 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 2010/11 and the prior year can be seen in more detail below (the reduction in Icelandic balances represents the repayments made by KSF).

Investment values over the prior 2 years



Similar to the borrowing comparators, there is currently no information available regarding other Local Authorities' investment performance during 2010/11.

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. The strategy for 2010/11 complied with updated code of practice and DCLG 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 in a separate Appendix. They cover the other side of investment and debt management referred to briefly in 5.1 above, this being capital expenditure, and they will be incorporated into the referral report to Council.

9 Conclusion

As for 2009/10, the main issue for 2010/11 treasury management relates to Icelandic investments although progress with the legal claims is being made to the extent that, within months, the Council should have a concrete figure in terms of the amounts to be recovered from Glitnir and Landsbanki.

Due to the ongoing impact of Iceland on the Council's risk appetite and the ongoing economic malaise, all other Treasury management activity has continued within a very narrow band of low risk products and counterparties maintaining the trend of relatively low investment returns compared to the pre Iceland years.