PERFORMANCE REVIEW MEETING

(Note this report needs to be reported on to Council, both for information and to update aspects of the Treasury Framework and therefore it will be included within the budget update report to Cabinet in December – for subsequent referral alongside other budget matters.)

2011/12 Treasury Management Progress Report to 30 September 2011

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 as part of the Council's performance management framework.

Council approved the Treasury Strategy including the Investment Strategy for 2011/12 at its meeting on 02 March 2011. This report outlines activities undertaken in pursuance of those strategies during the financial year up to the end of Quarter 2.

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 this is available through the Member Information section on the Intranet.

2. Summary

- Due to the upcoming HRA finance reforms, Cabinet is asked to note various changes to the Prudential Indicators presented at ***Annex B*** as well as changes to the Investment Strategy set out in section 9, for referral on to full Council.

- The decision from the Icelandic Courts was in the Council's favour. It is anticipated that the judgment is applied to all non test cases and that in broad terms the Council will recover all but £400K of the £6M invested.

- There is a £40K favourable variance against the budget to date. This relates to the 'accounting' interest accruing on Icelandic investments. Once full details of the settlement and timing are released, this will need to be reviewed.

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

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

3. Economic Review (section 3.1 to 3.4 as provided by Sector)

Global Economy

The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the £440bn bail out fund in September brought temporary relief to financial markets and it has now been agreed that private investors will take a 50%cut in the face value of their Greek bonds. Also, a new 130bn Euro bail-out of Greece by the EU and International Monetary Fund has also been agreed and together, these actions resulted in markets regaining their risk appetite as investors' confidence returned.

However, political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poors, has led to a much more difficult and uncertain outlook for the world economy.

Growth prospects in the US, UK and the Euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

UK Economy

Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.2% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects are expected to be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

Inflation remains stubbornly high, although the expectation of future falls, the external nature of the price increases (energy, oil, food etc.), and the negative impact a rate rise would have on the UK economy, are all likely to stop the Monetary Policy Committee from raising the Bank Rate for some considerable time to come. An indicator of the worsening position arose from the Monetary Policy Committee minutes recently, signalling a greater willingness to expand the quantitative easing programme.

International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels. This has been partially reversed by the recent Greek debt bailout as investors confidence returned, resulting in the biggest rise in the UK 10 year gilt yield for 2 years.

Outlook for the next six months of 2011/12:

There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the speed of economic recovery in the UK, US and EU;
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012;
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy;
- the degree to which government austerity programmes will dampen economic growth;

- the potential for more quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks' profitability and balance sheet imbalances.

The overall balance of risks is weighted to the downside:

- Low and modest growth in the UK is expected to continue, with a low Bank Rate to continue for at least 12 months. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However the current safe haven status of the UK may continue for some time.

Sector's Interest Rate Forecast

Sector's Interest Rate View													
	Now	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Sector's Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.50%
3 Month LIBID	**0.82%**	0.70%	0.70%	0.70%	0.70%	0.70%	0.90%	1.10%	1.30%	1.60%	1.90%	2.40%	2.70%
6 Month LIBID	**1.10%**	1.00%	1.00%	1.00%	1.20%	1.30%	1.50%	1.70%	1.90%	2.10%	2.40%	2.70%	3.00%
12 Month LIBID	**1.59%**	1.50%	1.50%	1.50%	1.60%	1.80%	2.00%	2.25%	2.50%	2.75%	3.00%	3.40%	3.70%
5yr PWLB Rate	**2.44%**	2.50%	2.70%	2.90%	3.00%	3.10%	3.20%	3.40%	3.60%	3.80%	4.00%	4.10%	4.20%
10yr PWLB Rate	**3.52%**	3.80%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%
25yr PWLB Rate	**4.56%**	5.00%	5.00%	5.10%	5.10%	5.10%	5.20%	5.20%	5.30%	5.40%	5.40%	5.50%	5.50%
50yr PWLB Rate	**4.73%**	5.00%	5.00%	5.10%	5.10%	5.10%	5.20%	5.20%	5.30%	5.40%	5.40%	5.50%	5.50%

Significance of Sector's Review to Lancaster

As will be discussed below, a key issue affecting the Council is the financing of the HRA subsidy buy out, planned for the end of this financial year. The review from Sector has an important influence on planning the treasury management elements of this transaction. The forecast indicates that returns on investment balances will remain at their historically low levels for at least another year, before a steady rise in bank rate over subsequent quarters.

In terms of borrowing costs, the international factors which impact on guilt rates, and therefore PWLB rates, may keep the cost of borrowing depressed, although the projection is for a steady rise up to, and beyond, the self financing date. The recent Greek debt bailout has already led to an increase in rates although it remains to be seen whether this confidence is maintained.

What seems likely is that the existing, significant margin between what rate the Council can achieve from investments and the rate it must pay for borrowing will be maintained over the medium term. In addition, the spread of rates, where shorter term loans are significantly cheaper, will be maintained, although the trend will be for this spread to reduce over time. These factors should be taken into account when developing the strategy for financing the estimated payment to DCLG – as will other factors outlined in the sections below.

4. Capital Budgets, the Debt Portfolio and HRA self financing.

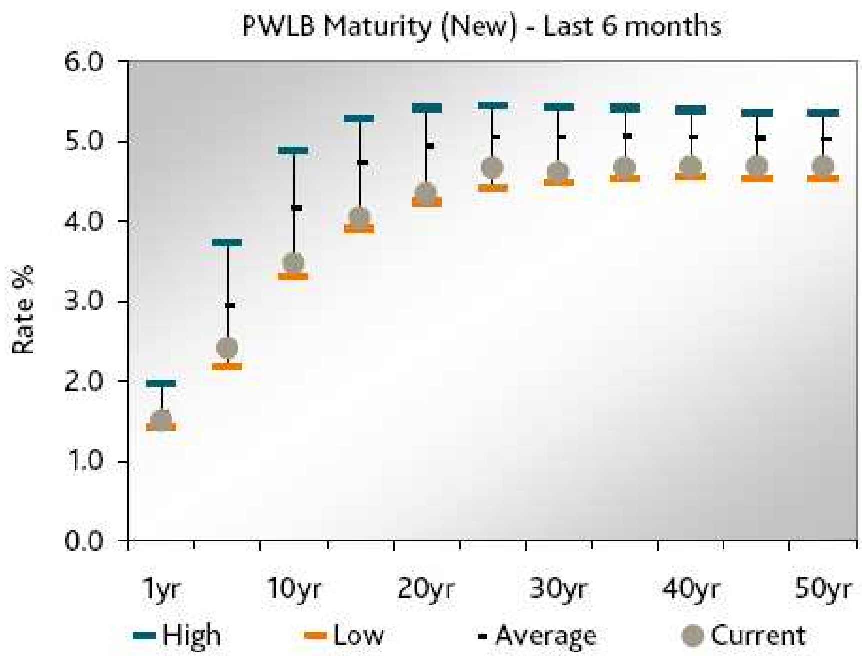
There has been no change to the long term debt portfolio since January 2009 and there is no immediate need to take out new long term loans. As noted later, the Council has positive news on Icelandic investments and as previously reported the two other big issues (Luneside and Land at South Lancaster) for the capital programme are nearing conclusion with reason for optimism on both fronts. The next major issue will be Council Housing self financing.

Officers need to develop a strategy for financing the likely settlement, currently estimated at £30M to buy out of the housing subsidy system. This will increase the underlying need to borrow but does not mean that the Council will have to borrow the whole amount. There may be an opportunity to net down the borrowing/investment balances, as has been discussed in previous quarterly updates. The upcoming capital budget process will also need to feed in to any strategy to finance the payment.

In anticipation of the self financing proposal being brought into law, a number of Prudential Indicators will need to be updated to reflect the changes to capital expenditure, debt and borrowing and the updated values are presented at ***Annex B***, for noting and referral onto full Council.

5. Current Borrowing Rates and special provision for HRA self financing.

The graph below shows that the pattern seen since January 2009 has persisted, with a marked spread between short term and long term borrowing. Further, rates remain at their depressed levels and have been on a downward trend, fuelled by the Eurozone crisis.



Extract from Sector weekly debt monitor 03 October 2011

This latest trend is good for the Council as it faces taking on new borrowing before the end of the financial year, in relation to the HRA subsidy buy out. The projections from Sector are, however, that these rates will rise before the self financing buy out but they will still remain relatively low. The spread of rates also means that structuring the maturity profile rather than relying on long term maturity loans, would be beneficial in terms of interest cost although it would commit the Council to either repayment or re-financing, sooner than if long terms loans were used.

Furthermore, the Government have announced that for HRA subsidy buy out purposes only, the margin which was added onto PWLB rates in October 2010 will be reversed on loans agreed by the 26th March 2012. This is further good news for Council as it will reduce rates by around 0.7%, which on £30M of debt, relates to an annual saving of around £210K.

The timing and level of resource available to make future repayments will be governed by the ongoing performance of the HRA. Therefore, before a meaningful borrowing strategy can be fully appraised and developed, consensus will be needed over the main principles of the 30 year HRA business plan, for example, rent levels and investment in the housing stock. In view of time pressures it could well mean that some of the more detailed aspects and options surrounding the HRA are developed for consideration later during 2012/13.

As noted in section 4, draft prudential indicators have been updated to ensure that the debt limits are raised sufficiently to allow for this transaction in the 2011/12 financial year. In addition, the target maturity profile of borrowings has been amended to allow maximum flexibility in planning the structure of any additional loans.

It should be noted that a figure of £35M has been used to amend the capital expenditure and debt figures as it is likely that the indicative amount of £30M will increase in the actual determination, although these final figures will not be released until January 2012.

6. Icelandic Investments Update

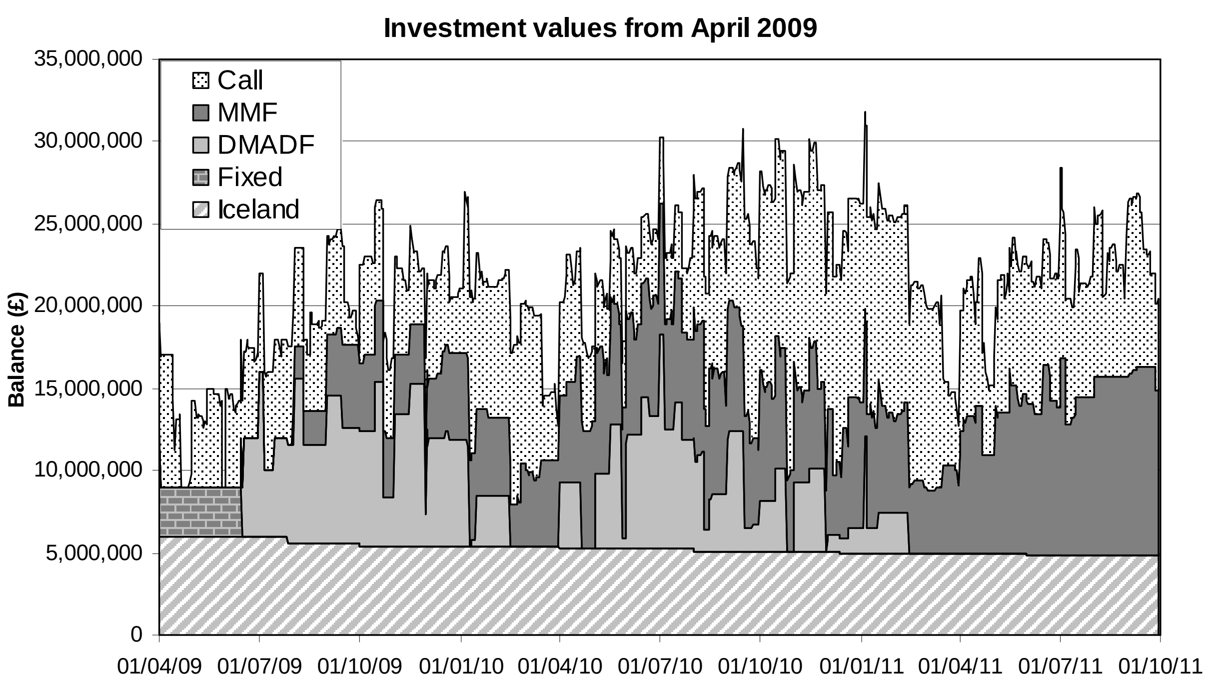
The Council has had very good news from the Icelandic Supreme Court which ruled that the local authority depositors tried as test cases, should have preferential creditor status. It is anticipated that this will be applied to the non test case authorities, including Lancaster. This means that the Council should get back all but around £400K of the £6M invested and some amounts of interest, although this is yet to be fully clarified.

The Council has already received around £1.3M (all from KSF), a further £3.3M could be paid as early as this financial year with the remaining £1M anticipated in smaller amounts to be paid over subsequent years. This is however, subject to confirmation from the administrators.

7. Other 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 2011/12. No fixed term investments have been placed; 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 2 is enclosed at ***Annex C***. The strategy approved for 2011/12 did not reduce credit criteria for counterparties but it did increase the investment limits for the small pool of counterparties that the Council places deposits with. This has meant that the DMADF account has not been needed in the last quarter. Instead, deposits have been held in instant access accounts that are higher yielding.



During the next quarter Officers hope to join a local Sector benchmarking group. This will allow the Council to compare its risk profile with other similar authorities as well as the returns being obtained for that level of risk. This should help inform the Investment Strategy for 2012/13.

In addition, the Council has opened a call account with Barclays which will come into use during Quarter 3. Although this does not pay as high a rate as some other call account offerings, it is judged to be more secure and would form part of the 'specified' investments unlike the other call accounts, which are included on the investment list partly on the basis of their access to government support. In addition, the County Council call account will come back into use. These actions mean that the very low yielding Government Liquidity MMF should not be needed in future.

8. 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	0.86%
Lancaster CC investments	0.63%

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

The approved Investment Strategy also allows for fixed term deposits up to 1 year with other local authorities. Further consideration will therefore be given to any such options in future, e.g. with the County Council.

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

Annual budget	£205K
Actual to date	£54K (see details in ***Annex C)***
"Icelandic" to date	£89K (see details in ***Annex C)***
Total	£143K
Variance	£40K favourable against evenly profiled budget

There is a £40K favourable variance which is mainly due to the impact of Icelandic investments. At the time the budget was set, the best estimate was that there was a 50/50 chance of full repayment in June 2011 which has not happened. The Icelandic element of the budget will need to be reviewed once the appeal case has concluded and the actual repayment amounts and dates are better known although it is judged likely that this will show a positive variance at out-turn. This should more than offset an increase in fees for the LGA/Bevan Brittan which are projected at around £3K more than was budgeted for in 2011/12, based on their latest fee estimates.

9. 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 risk exposure for investment remains comparatively low.

There is financial risk attached to the longer term debt portfolio, associated with interest rate exposure; there has been no change to this over the quarter. There is a risk for the new loans required for HRA self financing, although as noted in section 3, current rates are very low. As the HRA business plan is crystallised, an explicit strategy for the new debt will be developed including a policy to mitigate the interest rate risks. In anticipation of this, some of the prudential indicators have been amended and are presented at ***Annex B*** for noting and referral on to full Council.

In addition, it is requested that the counterparty limit for the Coop and the DMADF have a special condition applied until 28th March 2011 (payment date to DCLG) to allow these accounts to hold any amounts in relation to funds transferred to the authority in relation to HRA self financing. The intention being that funds would be held in the Coop for as short a period as possible with any elongated holding of funds (for example if there was a compelling argument to borrow early) being in the DMADF.

Finally, as per the previous year's quarterly updates, recovery of Icelandic investments is still being managed with legal support organised through the Local Government Association. This should reach a conclusion in Quarter 3.

10. Conclusion

The Council's treasury function has been on a low risk plateau since the Icelandic banking crisis; even though it now looks likely that the Council will get the vast majority of its Icelandic deposits back, there is no strong argument for moving away from this position.

The appetite for risk has remained very low with the use of either AAA rated MMFs, and instant access call accounts. The strategy for 2011/12 was approved at budget Council on 02 March 2011 and this has continued in the same vein as prior years, being very cautious, although with the limits on some counterparties increased. This is allowing more investments to be placed outside of the DMDAF account whilst maintaining high credit quality.

The main upcoming issue that will need addressing through 2011/12 is the HRA subsidy buy out. A detailed treasury strategy to support this is now being developed in parallel with the Council Housing 30-year business plan and in consultation with Sector, the Council's Treasury advisors.