APPENDIX K

Annual Treasury Management Report 2011/12

For noting by Cabinet 03 July 2012

1 Introduction

1.1 The Council's Treasury Management Strategy for 2011/12 was approved by Council on 02 March 2011. 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 with the guidance issued by both CIPFA and Government, as well as in line with the Council's appetite for risk. For 2011/12 the appetite for risk remained low given the continued volatility in the national economy and the Eurozone.

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 CIPFA code of practice (further updated November 2011). 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. More Member training is due to be organised with the Council's Treasury Management consultants, Sector, for later in the 2012/13 financial year.

2 Summary: Headline Messages for 2011/12

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

- There is still a great deal of uncertainty in the UK and wider economy, particularly with reference to the Eurozone debt crisis. Credit worthiness, including sovereign rating, is still a key issue.

- Positive judgments have been given over local authority Icelandic investments. The Council has received £4,125K to date and expects to receive £5.9M of its claims (£6M invested plus around £300K interest) in total.

- At the end of the financial year, the HRA self financing transactions took place; the Council took on additional long term PWLB debt of £31.241M to fund the payment (of an equal amount) for buying out of the Council Housing subsidy system.

- Excluding the HRA self financing payment, the underlying need to borrow decreased by £1.3M. General Fund capital out-turn resulted in a £2.3M increase in the underlying need to borrow, as compared with a revised budget of £2.4M; £780K of this related to vehicle purchases which are provided for in the revenue budget. Taking slippage into account, there were no major variations.

- 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 Council ended the year with healthy cash balances due to slippage on capital schemes and significant repayments from Glitnir and Landsbanki.

- The Council has stayed within its Prudential limits for investments and has not breached any of the criteria set out in the approved strategy. The use of the Lancashire County Council call account has meant that use of lower paying accounts such as the DMADF, has been kept to a minimum without compromising counterparty strength.

- Outturn on investment interest was £294K, which was £26K above the revised budget. This is due to slightly higher cash balances and the profiling of Icelandic bank repayments.

3 Economic background (supplied by Sector)

The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011/12 was that Bank Rate would start gently rising from Quarter 4 2011. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating.

Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA credit ratings from one rating agency during the year. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. Bank Rate therefore ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2%, finishing at 3.5% in March, with further falls expected to below 2% over the next two years. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece.

Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

Risk premiums were also a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment

4 Icelandic Investments

There was positive news from the Icelandic banks during the year. Following an elongated process local authority depositors were finally granted preferential creditor status with Landsbanki and Glitnir. This greatly increased the recoverable amounts and has lead to significant payments being made from these banks during 2011/12. The position is summarised below:

	KSF £000	Glitnir £000	Landsbanki £000	Total £000
Deposit	2,000	3,000	1,000	6,000
Claim	2,048	3,173	1,121	6,342
Payments received	1,290	2,508	327	4,125
Amounts held in ISK (£)		571	8	579
Total anticipated recovery (% of claim)	83.5%	100%	100%	
Further payments due (%)	20.5%	0%	70%	
Further payments due (£)	420	0	785	1,205
Total anticipated receipts	**1,710**	**3,079**	**1,119**	**5,908**

This shows that cash received as at 31/03/2012 was £4.125M. In total it is expected that the Council will get back £5.9M of its claims (£6M originally invested plus £342K interest etc). Although there has been a cost of the foregone interest during the period the money has been out of use, this means that the vast majority of the capital sum has been preserved.

The repayments from Landsbanki and Glitnir were made in a range of currencies reflecting the assets of the banks. Of these, amounts paid in ISK cannot currently leave Iceland due to currency controls imposed by the Central Bank of Iceland. These amounts have been paid into escrow accounts (similar to a client account at a solicitors) in Iceland. These are earning 3.4% interest but are also subject to gains and losses due to fluctuations in the exchange rate between Sterling and ISK. Once the currency controls are removed, these amounts will be paid back into the Council's UK bank account although there is currently no clear timeframe for this to happen.

The increase in recovery rates means that the amounts previously charged to the accounts for impairment of the investment values, can now be reversed. As part of closing down the 2011/12 accounts, all the amounts capitalised have been reversed out of the accounts with a resultant saving of £105K per year in financing costs (the saving already reflected in the 2012/13 budget). Overall, the outturn is around £30K worse than anticipated in the revised budget, taking into account the net entries to unwind the impairment reserve, the investment balance sheet values and notional interest credits. This is mainly due to not receiving the £47K of gap interest on the Glitnir repayment (that due between maturity date and 22 April 2009) which it had been anticipated would be due but which was not awarded by the Icelandic court. This was offset in part by slight improvements on the recoverable amounts.

As payments are still outstanding for KSF and Landsbanki, there may be small adjustments at subsequent year ends to reflect any changes to anticipated recoveries or repayment profiles, but it is not anticipated that these will be material.

5 Borrowing and capital expenditure.

5.1 Capital expenditure and financing.

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 has not 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 2011/12 the figures were as follows:

	£000
Opening CFR	53,294
Closing CFR*	83,188
Average CFR	**52,962**
Weighted average borrowings*	39,556
Weighted average finance lease liability	6,159
Weighted average investments	**18,928**
Net borrowings	**26,787**

*HRA self financing payment of £31.2M 28/3/2012 so only small impact on weighted average CFR & borrowings

From this it is clear that net borrowings are well below the Council's CFR. This shows that long term borrowing has not been used to fund revenue activities. These figures include the impact of the HRA self financing payment made on the 28 March 2012 and although this increased the closing CFR materially, on a weighted basis, as the transaction was so late in the year, it has little impact. Going forward, all that will happen is that net average borrowings and average CFR will increase by the value of the payment, that being £31.241M.

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

	2011/12	2010/11 (restated)*
	£000	£000
Opening Capital Financing Requirement	**53,294**	**53,285**
Capital investment		
Property, Plant and Equipment	7,526	8,397
Investment Properties	20	12
Intangible Assets	20	90
Revenue Expenditure Funded from Capital Under Statute	1,199	2,419
De capitalisation of Iceland	(1,364)	(222)
HRA self financing payment	31,241	0
Sources of financing		
Capital receipts	(760)	(718)
Government Grants and other contributions	(1,463)	(3,258)
Direct revenue contributions	(1,887)	(1,823)
Minimum Revenue Provision	(1,906)	(2,121)
Revenue contribution for Iceland	(408)	0
Major Repairs Reserve	(2,324)	(2,767)
Closing Capital Financing Requirement	**83,188**	**53,294**

*The 2010/11 CFR has been restated to reflect changes to finance lease entries due to changes to the Code and refinement of the discount rates used to measure the liabilities.

This shows a significant jump in the CFR over the year due to the HRA self financing payment. However, excluding the HRA element, there was a £1.35M reduction in the GF CFR.

The capital programme was budgeted to have a borrowing requirement of £2.41M whereas the actual amount needed was £559K. This included £777K for vehicles purchased rather than leased and the impact of accounting for Icelandic investments.

5.2 Borrowing levels

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). The boundaries originally set were adjusted part way through the year to allow for the HRA subsidy payment, the revised limits are summarised below:

	Actual Debt 31/03/12	Operational Boundary	Authorised Limit
	£000's	**£000's**	**£000's**
Deferred Liabilities	223		
Long term Finance lease liability	5,489		
PWLB Debt	70,636		
Total	76,348	82,000	87,000

It can be seen that the Council was well below the Authorised Limit and Operation Boundary at year end. The debt boundaries appear high in relation to the level of

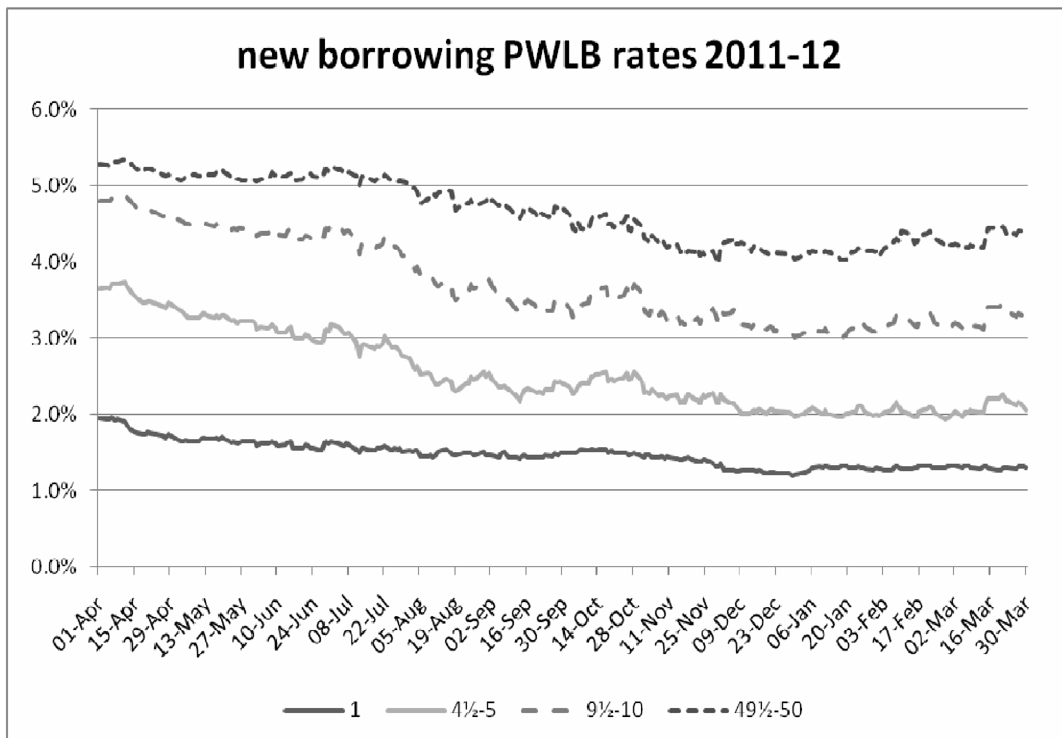
debt actually incurred, but these were originally set to provide flexibility for changes to the HRA settlement and to give some flexibility over elements of the capital programme where the Council has had limited control over expenditure.

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.

5.3 **PWLB Interest Rate Movements**

All of the Council's long term borrowings are held with the Public Works Loan Board (PWLB). As noted in section 3, during the year, Eurozone concerns increased demand for strong sovereign gilts decreasing the cost of borrowing for the UK Government; the cost of PWLB loans is directly linked to the cost of borrowing for the Government so this was beneficial for a Council such as Lancaster, facing a very large one off payment to DCLG for HRA self financing. In addition, the Government agreed a further discount to rates bringing them in line with the National Loans Fund rate (rather than adding a margin to this rate) and so the Council secured a 30 year EIP (Equal Instalments of Principal) loan from PWLB at a rate of 3.03%. This is judged to be very good value, as illustrated by comparison to the Council's fixed term loans, which average 5.68%.

The chart below illustrates the movement on PWLB fixed term rates over the year. This clearly shows the spread of rates depending on length of loan, which has been in place for several years. It also shows the downward trend of al rates, from an already low starting point.



Repayment of PWLB debt is still an attractive option in the current climate if a Council holds a grossed up position of higher borrowings matched by higher investment balances. There was an opportunity to underborrow for the HRA transaction but it was judged that given the rates were so low, it was advantageous to take on the cheap debt given that material schemes, such as Lancaster Indoor Market, may require significant cash resources. Further, should it turn out that there

is an excess of cash, taking on the cheap debt provides ballast for early repayments, ie any discount due on redemption of a cheaper loan could be used to offset the premia due on redemption of a more expensive loan. This will however be dependent on future capital expenditure, the timing of the receipt for land at South Lancaster and movement in interest rates.

5.4 **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 only change to the portfolio is the addition of the HRA loan. As this is on an EIP basis, elements of principal will fall due evenly over the life of the loan.

	Treasury Indicator	**Actual 31/3/11**	**Actual 31/3/12**
Under 12 months	0 - 50%	0%	1.5%
12 – 24 Months	0 – 50%	0%	1.5%
24 – 5 years	0 – 50%	0%	4.4%
5 – 10 years	0 – 50%	0%	7.4%
10 -15 years	0 – 100%	0%	7.4%
15 – 25 years	0 - 100%	0%	14.8%
25 – 50 years	50 – 100%	100%	63.0%

.

The actual profile of the debt is well within the approved limits (liabilities in relation to finance leases are not included within this indicator).

5.5 **Interest Payable on Longer Term Borrowing**

Ignoring the HRA debt taken on at the end of the year, the average rate of interest payable on PWLB debt in 2011/12 was 5.68% which is identical to 2010/11 and was on budget.

	£'000
2011/12 Estimate	2,227
2011/12 Actual	2,227 (of which £709K was re-charged to the HRA)
Variance	0

There was a small interest charge in 2011/12 on the £31.241M loan taken on to fund the HRA self financing payment, in relation to the period between the 28 and 31 of March but this will be covered by additional HRA subsidy payment.

There was also £488K 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 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**

6.1 **Performance against Prudential Indicators**

In 2011/12 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 2011/12; 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 these deposits are included in ***Annex B***.

As noted in section 4, part of the repayment from Glitnir and Landsbanki is currently held in ISK in an escrow account in Iceland. Strictly speaking this is a foreign exchange investment prohibited under the investment strategy, however, the Council has had no choice but to accept this repayment and will have to await relaxation of the currency controls in place in Iceland before these sums can be brought back under the Council's direct control. The total amount placed in escrow is £584K and between the time of deposit and year end, this had earned £1K of interest but had lost £6K in foreign exchange movement.

6.2 **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)	2011/12	2010/11
Base Rate	0.50%	0.50%
3 Month LIBID	0.97%	0.74%
Lancaster CC investment	0.63%	0.53%

The return is just above base but well below 3 month LIBID. This is because the Council has focused 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	£268K
Actual to date	£119K (see details in ***Annex B***)
"Icelandic" to date	£175K (see details in ***Annex B***)
Total	£294K

Variance £26K favourable

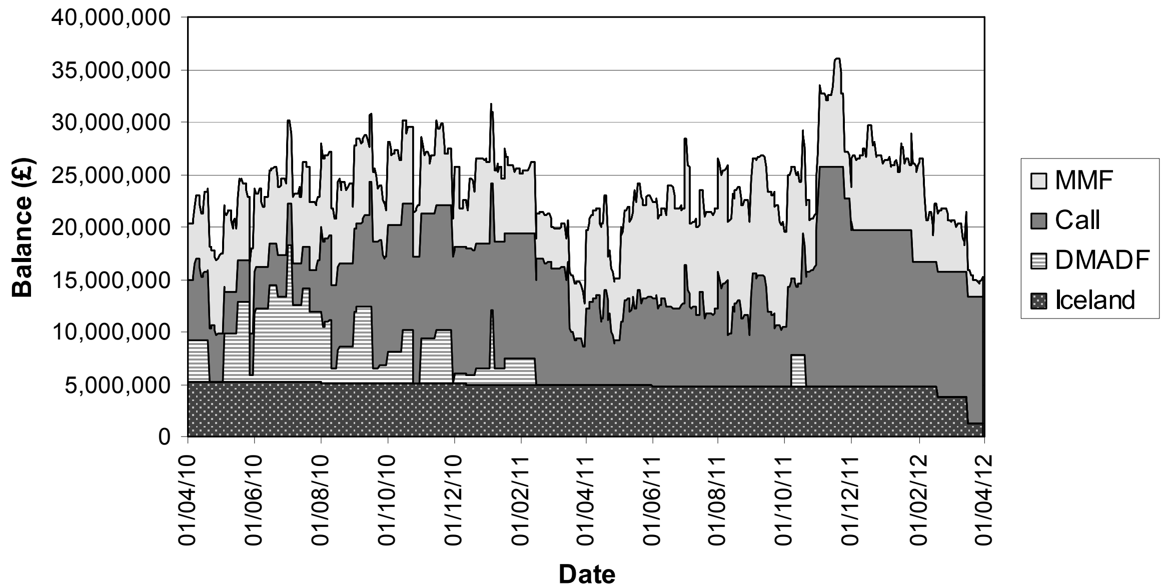
There is a £26K favourable variance. This is largely due to higher cash balances in the year than anticipated and re-profiling to the payments from Icelandic banks. Overall, the investment returns were within the range limited by the base rate and LIBID (London Inter-bank Bid) rate. In comparison to the prior year, the overall rate of return has improved although the absolute amount of 'real' interest (not including Iceland) remains low (£99K vs £119K), reflecting the continuation of the downturn which started in 2008/09.

As illustrated in the table below, the short term projection for rates is flat with moderate increases starting from March 2014; it is anticipated that the position on low investment interest rates will hold for the medium term.

Date	Bank rate projection (%)
01/06/2012	0.50
01/06/2013	0.50
01/03/2014	0.75
01/06/2014	1.00
01/09/2014	1.25

Source: Sector, June 2012

The Investment Strategy for 2011/12 continued with the more cautious approach to managing surplus cash which has been in place since the banking crisis. This approach has restricted the term of deposits, 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) with limit use of the DMO account. The pattern of these investments over 2011/12 and the prior year can be seen in more detail below.



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 and Treasury Indicators and the approved investment strategy, as discussed above.

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 2011/12 complied with updated code (November 2009) of practice and DCLG investment guidance. The Code was updated again during 2011/12 although there were no material changes in terms of how the Authority approaches risk management for its Treasury activities.

8 Other Prudential Indicators

As required under the Prudential Code, certain other year end Prudential Indicators must be calculated. Those not included within the body of this report are presented at ***Appendix L*** for noting by Cabinet and approval by Council.

9 Conclusion

During 2011/12 there was finally something not only conclusive but also positive in terms of the Council's Icelandic investments with the vast majority of the £6M invested now expected to be returned. However, there is still an economic overhang from the 2008/09 financial crisis, reflected in the ongoing low interest rates. Fortunately this has also worked in the Council's favour in terms of funding the payments made to central government under the Council Housing reforms.

A low risk appetite and the ongoing economic malaise mean that all investment activity has continued within a very narrow band of instant access deposit products and high quality counterparties, maintaining the trend of relatively low investment returns compared to the pre Iceland years. Given the interest rate projections, it is anticipated that this position will hold for the medium term although depending on the outcome of material capital schemes and receipts over the next 12 to 18 months, it may be possible to net down the Council's borrowings and investments to reduce counterparty risk and interest charges.

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.

- **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.
Eg. 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.

- **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.

- **Butlers** – Butlers Treasury 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.*