APPENDIX C

2012/13 Treasury Management Progress Report to 30 September 2012

Report of Head of Resources

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 2012/13 at its meeting on 29 February 2012. 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

- No further payments have been made by KSF and Landsbanki, leaving outstanding amounts due of £215K and £648K respectively.

- On other treasury matters, since the HRA self financing transaction at the end of 2011/12 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 update (provided by Sector)

The outlook for the global economy remains clouded with uncertainty. The UK economy has struggled to generate a sustained recovery so this offers little hope for a strong recovery in 2012, and possibly even into 2013. Consumer and business confidence levels are generally low and it is not easy to see potential for a significant increase in the growth rate in the short term.

Sector undertook a review of its interest rate forecasts following the issue of the Bank of England Inflation Report for August 2012. Consequently, it pushed back the first rise in Bank Rate from Q1 2014 to Q4 2014, as well as lowering the pace of rises in gilt yields.

The Bank of England forecasts of the speed and strength of recovery and rate of reduction of CPI inflation over the last four years had been attracting increasing criticism for being consistently over optimistic. In this latest Inflation Report, the Bank changed its position significantly in as much as it markedly downgraded its forecasts for the strength and speed of recovery in GDP growth. Whereas previously it had consistently been forecasting a strong recovery to over 3% p.a., it was now only forecasting growth to recover to around 2% during the period from early 2013 to the end of 2015.

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%
5yr PWLB rate	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.30%
10yr PWLB rate	2.50%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.20%	3.30%
25yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%
50yr PWLB rate	3.90%	3.90%	3.90%	4.00%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%

Economic forecasting remains difficult with so many external influences weighing on the UK. Key areas of uncertainty include:

- The impact of the Eurozone crisis on financial markets and the banking sector.
- The impact of the UK Government's austerity plan on confidence and growth.
- Monetary policy action failing to stimulate growth in western economies.
- The potential for weak growth or recession in the UK's main trading partners - the EU and US.

The overall balance of risks remains weighted to the downside. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However, near-term, Quantitative Easing (QE) is likely to depress yields and further QE thereafter may lead to a reassessment of Sector's central forecast.

4. Icelandic Investments Update

As reported in the year end report for 2011/12 there have been material repayments made against the Council's Icelandic deposits from all three banks. During quarter 1 repayments were received from KSF (10%) and Landsbanki (12%), and a further payment from Landsbanki was expected in quarter 3. The current position is summarised below:

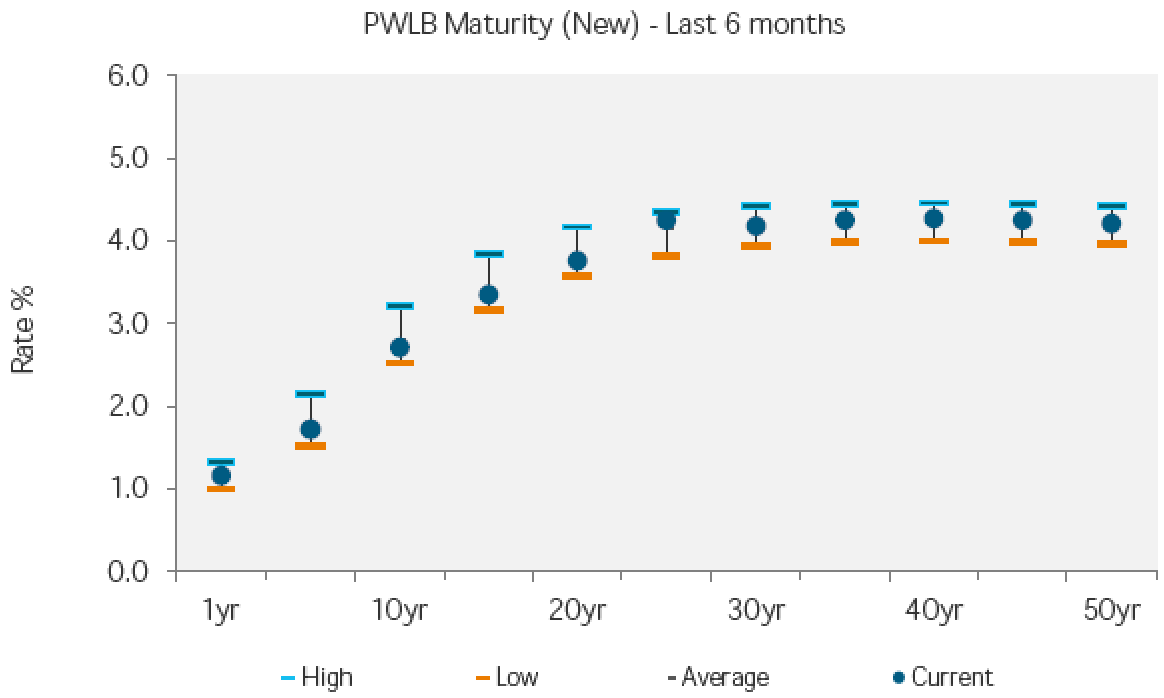
	KSF £000	Glitnir £000	Landsbanki £000	Total £000
Deposit	2,000	3,000	1,000	6,000
Claim	2,048	3,173	1,121	6,342
Payments received	1,495	2,508	464	4,467
Amounts held in ISK*		571	8	579
Total anticipated recovery (%)	83.50%	100%	100%	
Further payments due (%)	10.50%	0%	58%	
Further payments due (£000)	215	0	648	863
Total anticipated receipts	1,710	3,079	1,119	5,908

*These are earning interest but are also subject to currency fluctuations, these sums will be repatriated once Icelandic currency controls allow.

The total repayment in cash terms is now expected to be £5.9M meaning that the majority of the £6M principal invested will be returned.

5. Current Borrowing Rates.

There are few changes in relation to the cost of new debt. 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 even compared to the range seen over the last 6 months.



Extract from Sector weekly debt monitor 22/9/2012

However, as the Council is not currently looking to borrow, there is little immediate impact of these low rates. The main issue going forward could be that the margin between the Council's current loans and the threshold for avoiding penalties for early repayment will also increase but there are currently no plans to make early repayments and it will not be clear whether this is an attractive strategy until the cash demands linked to Lancaster Indoor Market are clarified, hopefully during quarters 3 and 4.

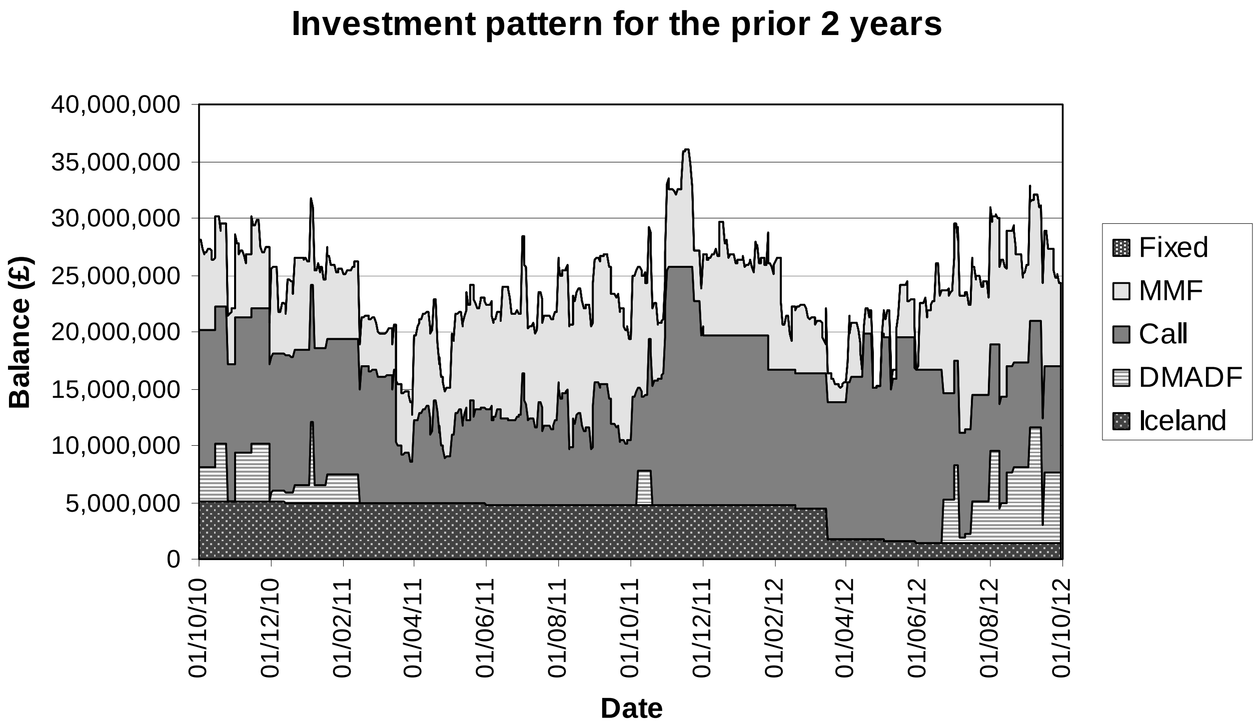
The £31M loan taken out at the end of March in respect of ending the HRA subsidy system was drawn down as an Equal Instalment of Principal (EIP) loan at 3.03% compared to the estimated 3.5%. This has resulted in annual saving of approximately £432K in interest which is split between the General Fund (£364K) and the HRA (£68K).

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 2012/13. 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 shown below.

Other Investments	opening	Min	Max	closing	Indicative rate	Cumulative Interest £
Call: RBS	3,000,000	3,000,000	3,000,000	0	0.80%	5,392
Call: Barclays	3,000,000	0	0	0	0.55%	3,707
Call: Lancashire County Council	6,000,000	6,000,000	12,000,000	9,300,000	0.70%	33,163
DMADF	0	0	10,140,000	6,200,000	0.25%	3,709
Government Liquidity MMF	0	0	6,000,000	1,370,000	0.30%	4,024
Liquidity First MMF.	1,850,000	0	6,000,000	6,000,000	0.65%	14,206
Sub-total	13,850,000			22,870,000		64,200
					Budgeted income	81,974



In the last quarter the Council has tried to make full use of the capacity with the County Council, once current cash demands become clear it may be that fixed term deposits are placed with County although they are at present fully borrowed and not taking on further deposits. Towards the end of the first quarter, credit rating changes to RBS and Barclays meant that these counterparties fell off the investment list. It may be that Members want to re-consider some of the limits agreed within the 2012/13 strategy to allow instant access deposits with these institutions to continue, however, until such a review, these banks will not be used. Proposals are being developed for consideration by Members and will be reported through in due course.

Given this and the reduced ability to place deposits with County, lower yielding accounts have been used such as the DMADF and governmental MMF accounts with a resultant loss of investment income. In addition, cash balances are lower than anticipated in the budget, the main reason being the ongoing delays with realising material capital receipts.

7. Summary of Budget Position and Performance

In terms of performance against external benchmarks, the return on investments compared to the 7 day LIBID and bank rates over the year to date is as follows:

Base Rate	0.50%
7 day LIBID	0.43%
Lancaster CC investments	0.57%

The return is just above base and is better than the 7 day LIBID benchmark which is positive given that the Council's investments are in the main on instant access. In absolute terms as the Council has focused on secure and highly liquid deposits the rate of return is very modest however, for the type of investment the Council is making, it is a reasonable rate.

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

	Annual Budget	Profiled Budget	Actual to Date	Variance
	£'000	£'000	£'000	£'000
Icelandic Credits	50	25	25	0
Cash Interest	164	82	64	18
Total	**214**	**107**	**89**	**18**

There is an £18K adverse variance which is jointly due to lower cash balances than anticipated, as noted in section 6, as well as reduced capacity on higher yielding accounts following limits placed by the County and credit rating reductions to Barclays and RBS.

The credits from Icelandic investments are accounting adjustments to the investments that still held with the Icelandic banks. These are real credits to the General Fund balance but are subject to adjustments depending on changes to the repayment profile of outstanding amounts. At present there is no reason to alter the assumptions made at budget time but this will be kept under review.

8. 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 counterparty risk exposure for investment remains low.

There is financial risk attached to the longer term debt portfolio, associated with interest rate exposure but all of the debt is on fixed interest and there has been no change to this over the quarter. The low rates create a risk in terms of the ability to repay debt but the Council is not yet in position to be following such a strategy.

There have been very positive developments with the Icelandic banks over the last 2 quarters and the risk attached to uncertainty of the Council's creditor status has now been extinguished. There are still uncertainties over the timing and exact amounts of repayments, as well as how elements already repaid in ISK will be repatriated.

Further, there is an interest rate risk attached to the current investment strategy where the Council, as at September 2012, had no high street banks it could deal with, even on an instant access basis. The cost/benefit of the current strategy in being reviewed to ensure that the risk of foregone income is being actively monitored against a level of counterparty risk that is acceptable.

A copy of the approved Prudential and Treasury Indicators is included for reference at ***Annex B***.

9. Conclusion

The Council's treasury function has been on a low risk plateau since the Icelandic banking crisis and there is no strong argument for moving away from this cautious position. However, with an ever decreasing investment list, there is some argument for a minor relaxation of limits in specific circumstances or movement away from a lowest common denominator approach to a more 'average' based approach, such as Sector's traffic light system. This will be taken forward over the next quarter for Members consideration, should workloads allow.

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.

- **Call account** – instant access deposit account.

- **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.

- **Money Market Fund (MMF)** – Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.

- **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.

- **Sector** – Sector 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.*

PRUDENTIAL & TREASURY INDICATORS

Approved by Council 29 February 2012

			2012/13 £'000	2013/14 £'000	2014/15 £'000

AFFORDABILITY

			2012/13	2013/14	2014/15
PI 1:	Estimates of ratio of financing costs to net revenue stream	Non - HRA	16.3%	13.3%	12.7%
		HRA	24.6%	23.0%	21.7%
		Overall	19.6%	17.2%	16.3%
PI 2:	Actual ratio of financing cost to net revenue stream		Reported after each financial year end		
PI 3:	Estimates of the incremental impact of new Capital Investment decisions on the Council Tax		£5.59	£0.00	£0.00
	This includes the impact of all elements of funding, including any increase in the need to borrow, required to finance new schemes added to the Capital Programme		2.9%	0.0%	0.0%
PI 3A:	Illustrative Impact of Additional Borrowing £1 million		**Repayment Period**		
			5 Years	**10 Years**	**25 Years**
	Increase in Council Tax (£)		£4.81	£2.57	£1.38
	Increase in Council Tax (%)		2.50%	1.34%	0.72%
PI 4:	Estimates of the incremental impact of Capital Investment on Housing Rents		Nil	Nil	Nil

CAPITAL EXPENDITURE

			2012/13	2013/14	2014/15
PI 5:	Estimates of capital expenditure	Non - HRA	4,099	3,311	1,066
		HRA	3,916	3,616	3,616
		Total	8,015	6,927	4,682
PI 6:	Actual capital expenditure		Reported after each financial year end		
PI 7:	Estimates of Capital Financing Requirement	Non - HRA	28,850	28,474	27,459
		HRA	45,264	43,984	42,704
		Total	74,114	72,458	70,163
PI 8:	Actual Capital Financing Requirement		Reported after each financial year end		

EXTERNAL DEBT

		2012/13	2013/14	2014/15
PI 9:	Authorised Limit			
	Authorised Limit for Borrowing	75,500	75,500	75,500
	Authorised Limit for Other Long Term Liabilities	2,700	2,500	2,300
	Authorised Limit for External Debt	78,200	78,000	77,800
PI 10:	External Debt: Operational Boundary	73,200	73,000	72,800
PI 11:	Actual external debt	Reported after each financial year end		
PI 12:	HRA limit on indebtedness	60,194	60,194	60,194

PRUDENCE

		2012/13	2013/14	2014/15
PI 13:	Treasury Management: adoption of CIPFA code of Practice	The Council has adopted the updated Treasury Management code of practice (2011).		
PI 14:	Net debt and the capital financing requirement			
	Anticipated indebtedness (operational boundary)	73,200	73,000	72,800
	Anticipated investment	14,930	13,990	14,920
	CFR	74,114	72,458	70,163
	Under/over borrowed (-/+)	-14,016	-14,532	-17,557

TREASURY MANAGEMENT

			2012/13	2013/14	2014/15
TMI 1:	Fixed Interest Rate Exposure The Authourity will limit its exposure to fixed interest rate costs to the amounts payable on the		100%	100%	100%
TMI 2:	Variable Rate Interest Rate Exposure The Authourity will limit its exposure to variable interest rate costs to the amounts payable on the		30%	30%	30%
TMI 3:	Maturity Structure of Borrowing				
	Upper and Lower Limits	Under 12 months	0% to 50%	0% to 50%	0% to 50%
		12 months and within 24 months	0% to 50%	0% to 50%	0% to 50%
		24 months and within 5 years	0% to 50%	0% to 50%	0% to 50%
		5 years and within 10 years	0% to 50%	0% to 50%	0% to 50%
		10 years and within 15 years	0% to 100%	0% to 100%	0% to 100%
		15 years and within 25 years	0% to 100%	0% to 100%	0% to 100%
		25 years and within 50 years	50% to 100%	50% to 100%	50% to 100%
	Maturity Profile of Current Outstanding Debt*	Under 12 months	0%	0%	0%
		12 months and within 24 months	0%	0%	0%
		24 months and within 5 years	0%	0%	0%
		5 years and within 10 years	0%	0%	0%
		10 years and within 15 years	0%	0%	0%
		15 years and within 25 years	0%	0%	0%
		25 years and within 50 years	100%	100%	100%
TMI 4:	Investments for periods longer than 364 days The Authority will not invest for periods of longer than 364 days.		Nil	Nil	Nil