PERFORMANCE REVIEW TEAM

2009/10 Treasury Management Progress Report to 31 December 2009

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.

Cabinet approved the Treasury Strategy for 200/10 on 17 February 2009 and the Investment Strategy was approved by Council at its meeting on 04 March 2009. This report outlines activities undertaken in pursuance of those strategies during the financial year.

2. Summary

- £410K was received from KSF (£2M deposit) in July, an additional deposit of £205K was received in December.

- The council's preferential creditor status in relation to Glitnir has been challenged. The outcome of this ruling will have a large impact on the return from this investment and potentially that with Landsbanki.

- There have been no changes to the debt portfolio and it not anticipated that any new long term borrowing will be required before the year end.

- An RBS call account has been opened. This is a Government controlled, eligible institution and so is being operated in line with the upper limit institutions as defined in the investment strategy.

- 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. Icelandic Investments Update

The main event during the quarter was that the council's preferential creditor status has been challenged by the Glitnir winding up board on the basis that our investment was a loan and not a deposit. The reasoning for this is unclear and the decision is to be challenged through the Icelandic courts. The outcome of the ruling will have a large impact on the returns which could drop from an anticipated 100% under preferential status to around 30% for non preferential status (on a principal of £3M). We currently have preferential status with Landsbanki but should Glitnir's objection be upheld, it is anticipated that Landsbanki would also attempt to challenge our preferential status. The process is ongoing and is being managed by Bevan Brittan, via the LGA, on behalf of all authorities with frozen Icelandic deposits.

In terms of the budgetary impact and accounting for a potentially much larger impairment loss, a capitalisation bid has been submitted to DCLG for £2.1M (to cover the additional potential losses on Glitnir). This will allow the council to amortise the loss over 20 years rather than taking the full impact in 2009/10. This does not include any provision for further losses on Landsbanki as the DCLG would only let the council assume best case for this counterparty even though there is a risk that this will change, pending the outcome of Glitnir (*update as required*).

A payment from KSF was received in late July for £410K and a further payment was received in December for £205K; the final settlement has still to be determined.

It is anticipated that CIPFA will release further bulletins relating to accounting for Icelandic deposits as and when more information is available.

4. Debt Portfolio

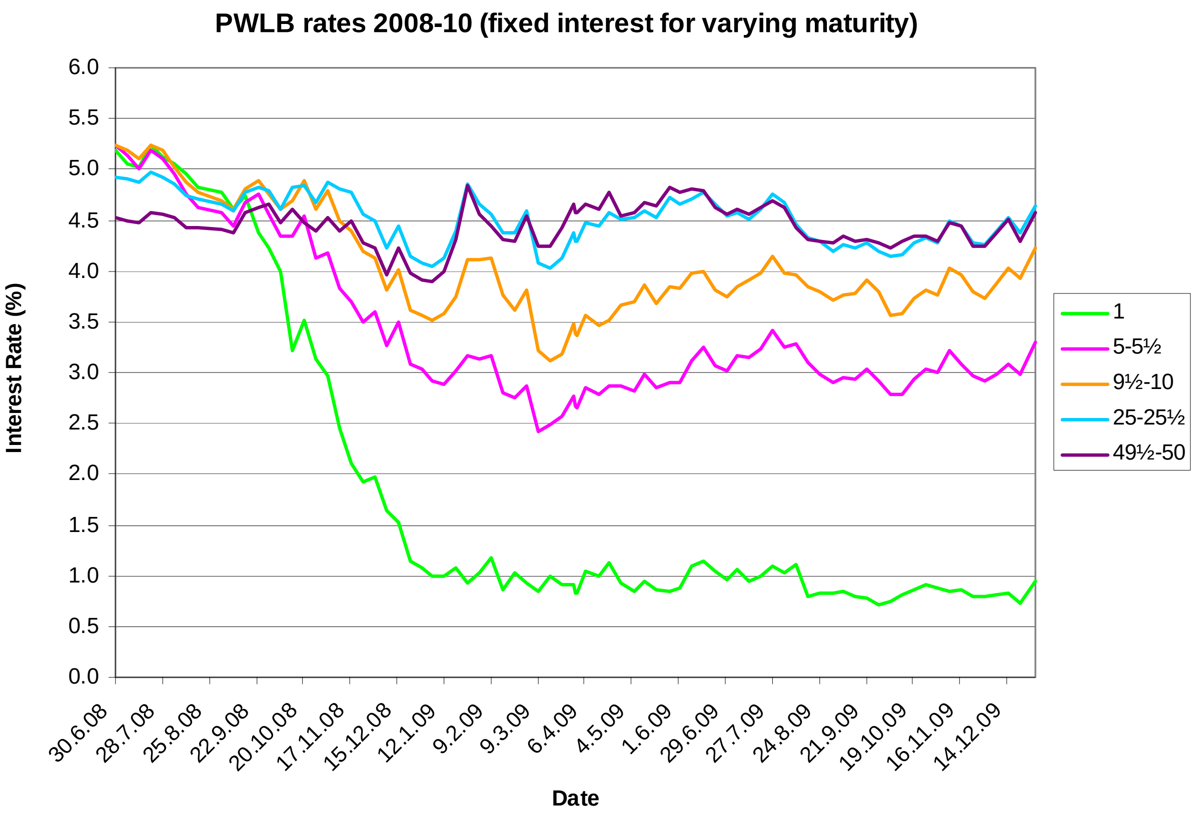
The opening level of longer term debt for the period was £39.4M. During the quarter, in cash flow terms there was no new long term external borrowing required, despite the Council's Capital Financing Requirement being around £45.8M. The closing balance of longer term debt was therefore still £39.4M - the bulk of this relates to Public Works Loan Board (PWLB) loans of £39.2M. This is well within the Operational Boundary, which is set at £56M. All of the Authority's debt is currently fixed term and due to mature in 10 or more years. This means that during the quarter the Authority was within all relevant Prudential Limits (see ***Appendix A*** for full listing of indicators).

There is no immediate need to take out new long term loans at present to help fund capital investment, because cash flow is still relatively strong, despite the difficulties with Icelandic investments. In very broad terms, this is primarily because of the amounts being set aside each year from the budget for the future repayment of debt, through the Minimum Revenue Provision (MRP). At present it is still favourable to avoid taking out any new longer term borrowing. This is because there is less resulting counterparty risk involved and new long term loans would cost more than the returns, if the council were to invest an equivalent sum.

However, as in prior years, the council is facing some challenges in terms of realising the capital receipts that underpin the capital programme. The programme for future years is currently being refined through the annual budget process, the outcome of which will influence whether the council decides to take on any prudential borrowing in future – affordability being a key concern. There are two major unknown factors, additional to Iceland that will also have a significant bearing on this, these being capital receipts for the land at South Lancaster and potential Luneside East compensation claims. The capital programme and debt strategy will be updated accordingly, as and when more detail emerges on these issues.

5. Current Borrowing Rates

The graph below shows that the pattern seen over the prior year has persisted with shorter term loans remaining well below the interest rates from 18 months ago, with higher rates for longer loans. Short term borrowing remains historically low and longer term rates remain relatively low should any further borrowing be required. The conditions for borrowing will be actively monitored as the capital investment requirements for future years are crystallised.



6. Investing Activities

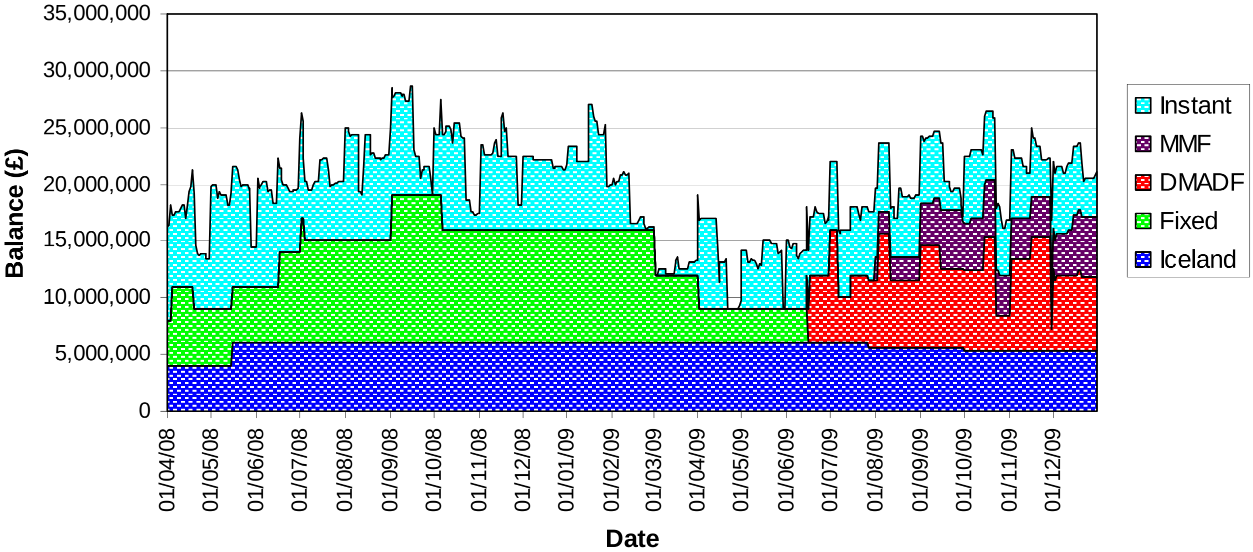
As laid down in the approved Investment Strategy, the aim is to prioritise security and liquidity of the council's investments. This is to minimise any further chance of a counterparty failing and the council not being able to remove its deposits, as happened with the Icelandic banks.

All investment activity has been in line with the approved Treasury Strategy for 2009/10. No fixed term investments have been placed since September 2008, with the exception of Debt Management Accounts Deposit Facility (DMADF) deposits (i.e. with HM Government). Any other surplus cash has been managed on a day to day basis using the call accounts and since August, two Money Market Funds (MMF). A full list of the investments placed during the year is enclosed at ***Appendix B*** along with details of the balances on liquid deposits held.

The split of investments is shown graphically below (see also further details in ***Appendix B***). It is clear from this that the investment portfolio is split between Call accounts, the DMADF and MMFs. This keeps deposits secure, liquid and spread over a number of counterparties. £615K has been repaid to date by KSF which has reduced the balance outstanding with Icelandic banks (at this stage, it is assumed all of this relates to the principal).

In addition, during the period, a further call account was opened with Royal Bank of Scotland.

Investment values over the period (fixed vs instant access)



7. **Summary of Budget Position and Performance at 30 September 2009**

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	0.91%
Lancaster CC Investments	0.58%
Lancaster CC investments*	0.83%

*This rate includes £5.4M frozen in Icelandic banks, assumed at 0%. Although as per accounting guidance, we can accrue for this interest, it is both notional and subject to amendment depending on the terms of the ultimate settlement.

This performance appears good but it should be noted that it is affected by fixed term investments that were taken out before the global economic down-turn.

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

Annual budget	£86K
Profiled budget	£61K
Actual to date	£82K (see details in ***Appendix B)***
Variance	£19K (favourable)

The reason for the favourable position is due to the slight fluctuation in interest receipts over the course of the year. The amount of investment balance will run down over the last quarter as income from Council tax and NNDR stops; the £86K annual figure is judged to be a good estimate of the final out-turn.

These figures do not take account of interest from Icelandic investments. At this stage it is considered likely that the Council will be able to recognise interest from these investments although, as previously reported, accounting requirements mean that this will be used to offset the losses in principal expected.

8. **Risk management**

The main focus of risk within treasury management currently is security of deposits and their liquidity. The Council's investment strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and length of deposit, together with supporting advice. Officers have been maintaining the portfolio well within the agreed limits by utilising instant access call accounts and avoiding any new fixed term investments except for short term deposits with the DMADF. The view is, therefore, that associated risks have reduced over the period and are low, as at 31 December. Since Quarter 1 the portfolio has been diversified by using AAA rated Money Market Funds. At present these accounts are paying lower rates than the call accounts, but slightly higher than the DMADF, and they have added further capacity that is considered both secure and liquid. They are therefore judged to be acceptable in risk terms.

There is also a liquidity risk associated with needing access to cash on a day to day basis. At the end of the period the Authority had cash balances of £15.6M, £9.2M of which was held on instant access. As such, liquidity is not judged to be significant risk at the present time.

Aside from the above, there is also financial risk attached to the longer term debt portfolio, associated with interest rate exposure. Until such time as PWLB repayment rates improve though, as mentioned earlier, there are unlikely to be any further actions that can be taken to improve further the Council’s position. In addition, due to the unknowns linked to capital programme, there is a risk that the Council may have to take on further borrowing. However, with rates, particularly on shorter term loans, at very low levels, this is relatively good period to take on borrowings if required.

Finally, with regard to recovery of Icelandic investments, this is still being managed with the support through the Local Government Association. It is judged that this is the most effective way of maximising recovery on the Council’s behalf. Following Glitnir’s challenge to our creditor status, there is a risk of increased losses, however, Bevan Brittan and the LGA are acting on behalf to help minimise this.

9. Conclusion

The third quarter of the year has been relatively uneventful for Treasury Management, with the exception of Glitnir’s challenge to the council’s preferential creditor status.

Over the quarter there have been no material breaches of counterparty limits or other prudential indicators. The Authority is starting to see the full impact of interest rate reductions on investment returns. Investment returns are expected to fall back in line with budget as surplus cash runs down over the last quarter.

The appetite for risk has remained low with the use of either AAA money market funds, instant access deposit accounts or deposits with HM Treasury. These have been used in preference to making the general fixed terms deposits which would previously have been used.

The information currently available regarding Icelandic investments gives some cause for concern in relation to the Council’s creditor status. The decision on this will have a large impact on the Council’s position in terms of cash balances and revenue charges relating to the impairment. Further information on the decision and accounting is awaited.