CABINET

2011/12 Treasury Management Progress Report to 30 June 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 1.

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. Member training has been organised with the Council's Treasury Management consultants, Sector, later this month.

2. Summary

- There is no further news in relation to Icelandic banks, it is hoped that a decision will be made in the Icelandic courts around the end of Quarter 2.

- There is a £19K favourable variance against the budget to date. This relates to Icelandic investments, but it will need to be reviewed once it is clearer when and how much the Council will be getting back from Landsbanki and Glitnir.

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

- There have been no material breaches of any prudential indicators or counterparty limits in the quarter and no other major risks have been identified (a full list of the approved PIs is attached for information at ***Annex B***)***.***

3. Economic Review (as provided by Sector)

The economic recovery has been struggling to regain momentum after underlying activity more or less stagnated between October and March. The number of job vacancies continued to fall throughout the quarter and the claimant count measure of unemployment also continued to rise over the last three months although this partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes. The housing market has continued to tread water with the number of mortgage approvals for new house purchases broadly unchanged at a very low level, in the region of 46,000. House prices have also remained broadly flat.

The additional bank holiday for the Royal Wedding pulled down both industrial and services output in April. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday as retail sales volumes fell in May, more than reversing April's increase.

Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q4 of 2010/11 as inflation outpaces average earnings by about 2.5%. The near-term outlook for inflation has deteriorated further; although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further and Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit. This is in contrast to the median pay settlement which was unchanged at 2.5% in May.

Most Monetary Policy Committee members still think that the rise in inflation will be only temporary and that inflation will fall back sharply next year. So despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise.

Overall, the economy remains in a delicate state with decreased chance of imminent interest rate rises compared to the prior quarter. This is bad in terms of investment returns but may be beneficial if additional debt is required to finance the HRA subsidy buy out discussed in sections 5 and 6 below.

4. Icelandic Investments Update

There has been no news on the Icelandic investments since the end of 2010/11. The Council is still awaiting a decision from the Icelandic courts on the creditor status of UK local authorities but it is hoped that this will be reached sometime in October 2011. Once this issue is resolved it will be much clearer as to the level of recovery on Glitnir and Landsbanki.

During the quarter, KSF made a further 5% repayment, bringing the total to 58% of the claim value (£1,160K of the £2M principal).

5. Capital Budgets and the Debt Portfolio

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. The capital expenditure from 2010/11 has not generated any further actual need to borrow and the budget for 2011/12 is for capital funding to greatly exceed the capital expenditure with the excess being used to write down the Capital Financing Requirement. This is however contingent on the completion of the sale of land at South Lancaster.

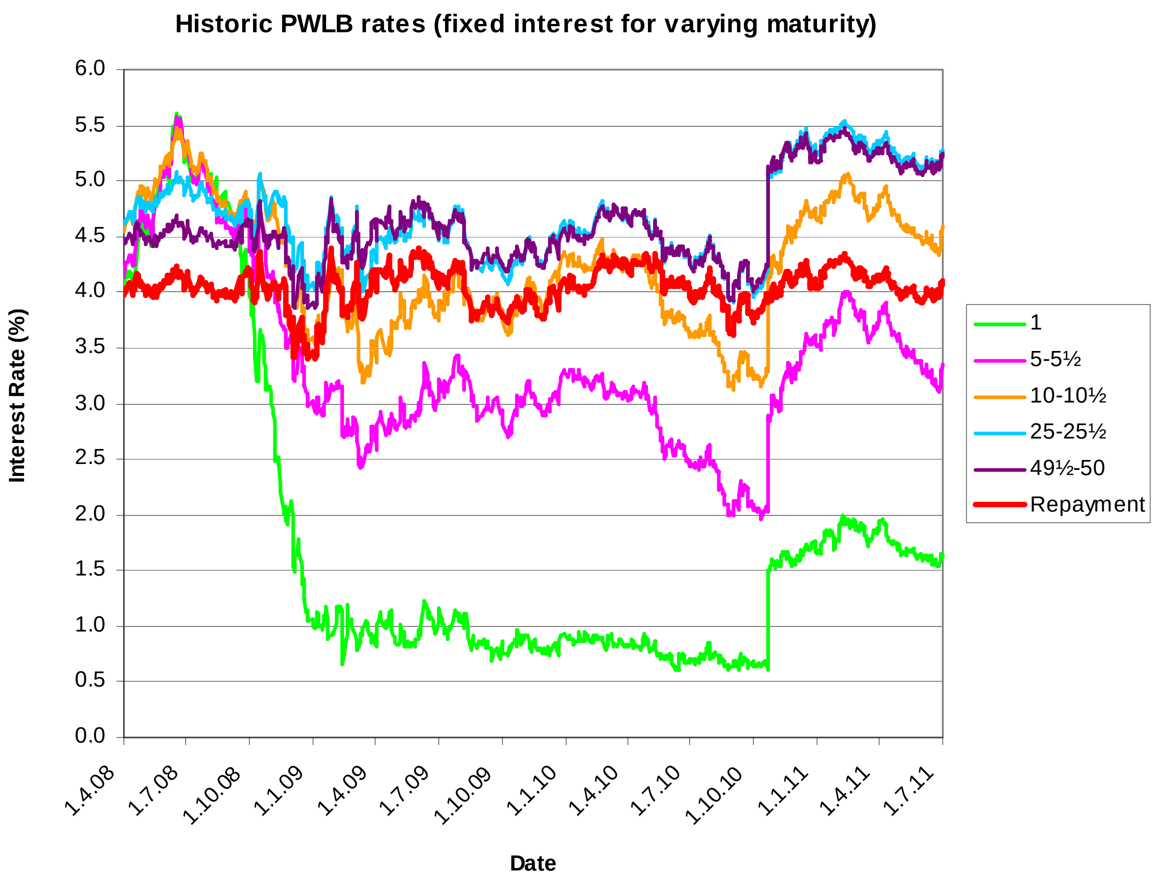
In addition, should the favourable verdict on Icelandic bank creditor status be upheld at appeal, the £2.1M capitalised expenditure added to the Council's underlying borrowing need (under directive in 2009/10) would be reversed in full. Further, the current expectation is that there should be no further significant payments in relation to Luneside East land acquisitions, although that too is awaiting conclusion at the Lands Tribunal.

Overall then, the three big issues (Iceland, Luneside and Land at South Lancaster) for the capital programme are nearing conclusion with reason for optimism on all fronts. The next major issue will be Council Housing self financing. Officers will need to develop a strategy for financing the likely settlement (currently estimated in the region of £30M of additional debt to buy out of the subsidy system), taking into account the anticipated levels of borrowing and cash balances available to fund the buy-out. This may be an opportunity to net down the borrowing/investment balances, as has been discussed in previous quarterly updates.

6. Current Borrowing Rates

The graph below shows that the pattern seen since January 2009 has persisted, with a marked spread between short term and long term borrowing. The main feature is the jump in rates across the board on 20 October 2010 when central government added 1% to the cost of borrowing through the PWLB. Over the quarter there has been a reduction in rates across the board, which reflects UK gilts faring relatively well in the face of sovereign debt difficulties in the Eurozone.

In relation to existing debt, the Council's cheapest major loan is at 4.6%. Only when the repayment rate rises to 4.6% could this be repaid early without penalty and as can be seen from the graph, the early repayment rate is still well below this, fluctuating around the 4% level. However, as noted in 5 above, the proposed HRA subsidy buy-out will be an opportunity to review the investment and debt portfolio and it may be that some internal cash can be used to part finance any buy out, if this is better value than taking on full additional borrowing.

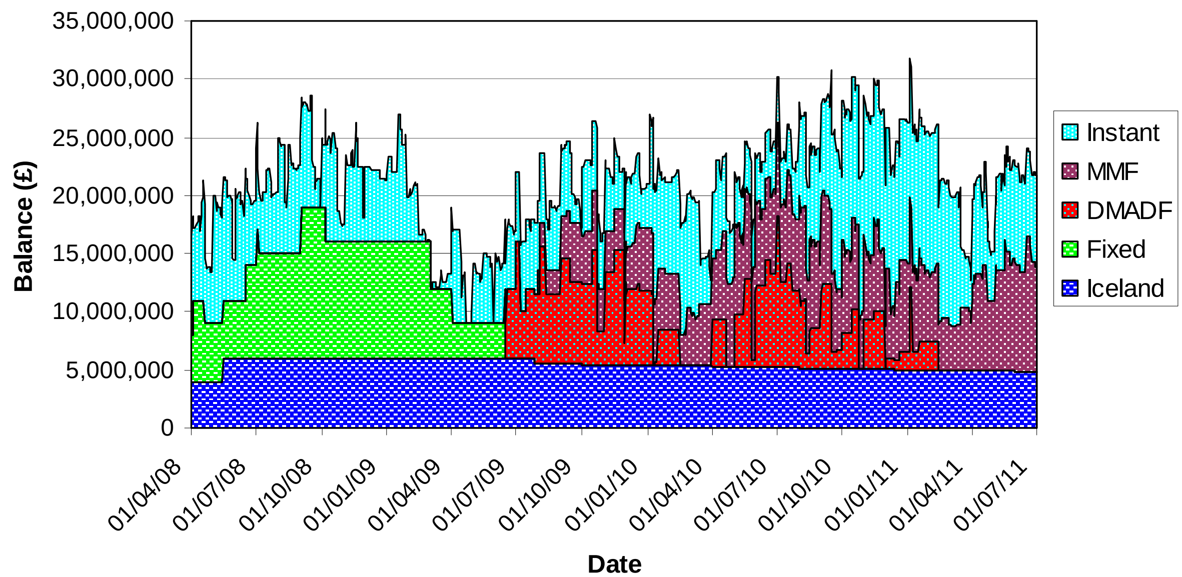


7. Investing Activities

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 1 is enclosed at ***Annex B***. 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 quarter. Instead, deposits have been held in instant access accounts that are higher yielding.

Investment values over the prior 2 years



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	0.82%
Lancaster CC investments	0.65%

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	£26K (see details in ***Annex C)***
"Icelandic" to date	£44K (see details in ***Annex C)***
Total	£70K
Variance	£19K favourable

There is a £19K favourable variance which is 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. 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.

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. Although PWLB have increased their rates for new loans, this is not judged to impact on the risks linked to the current portfolio. To mitigate the risk attached to any new borrowing, market data will be used to ensure value for money is assured on any new debt. This is particularly relevant given the proposed buy-out of the HRA subsidy system referred to in sections 5 and 6.

As noted in section 5 above, although there is reason for optimism, there is still uncertainty over some material elements of the capital programme. The financial risk that this creates is managed through regular reviews of expenditure to date as well as integration between capital budgeting and the treasury strategy; these risks are also managed through the Prudential Indicators, a full list of which is attached for information at ***Annex B***.

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 around the end of Quarter 2.

10. Conclusion

The Council's treasury function has been on a low risk plateau since the Icelandic banking crisis; given the delicate state of the economy 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.

Some significant progress has been made in the recovery of Icelandic investments with the Icelandic District Court ruling in councils' favour, however, a final judgement is still awaited by the Supreme Court. The main upcoming issue that will need addressing through 2011/12 is the HRA subsidy buy out. A detailed treasury strategy to finance the potential buy out will be developed in parallel with the Council Housing 30-year business plan and in consultation with Sector, the Council's Treasury advisors.