Appendix A

Review of Treasury Management 2011/12

Introduction

In February 2012 the Council adopted the 2011 edition of the *CIPFA Treasury Management in the Public Services: Code of Practice*, which requires the Council to approve a treasury management strategy before the start of each financial year, and provide both a mid-year review, and an annual report after the end of each financial year. This report is the annual report for the 2011/12 financial year.

1. Economic Summary 2011/12

The Eurozone debt crisis dominated the year's economic news, as investors positioned themselves for potential government defaults or even the breakup of the Eurozone itself. Investor confidence in struggling Eurozone nations, such as Greece, Italy and Spain, dived, prompting sharp upward movements in government borrowing rates in these countries. Greece finally defaulted in March 2012 by forcing private bondholders into a distressed debt exchange, in return for a second bailout from the European Union and the International Monetary Fund.

Exposure to the Eurozone periphery, coupled with actions making future government support less likely, placed downward pressure on the creditworthiness of many European banks, prompting a raft of credit rating downgrades and sharp rises in credit default swap spreads.

In late December, the European Central Bank cut interest rates and flooded the Eurozone banking sector with cheap three-year loans, immediately reducing the near-term risk of a liquidity crisis and moderating Eurozone wholesale interbank lending rates. Unfortunately, central bank action could not prevent the debt crisis causing a sharp decline in household and business confidence, eventually pushing the Eurozone into recession.

The UK's reliance on the Eurozone as a major trading partner was illustrated when this country followed the Eurozone into recession over the last six months of the financial year.

Weakening economic growth and signs of further deterioration in the Eurozone prompted the Bank of England to continue loose monetary policy, despite above target inflation. In October, with Bank Rate already at 0.5%, the Monetary Policy Committee voted for a further £50bn of quantitative easing, which combined with safe haven buying to push gilt yields to record lows over the following months. Policymakers justified the action because they were confident inflation would fall quickly back to target during 2012. However, although the annual Consumer Price Index rate has declined from the September peak of 5.2%, a combination of higher crude oil and food prices caused the rate to rise slightly in March to 3.5%, leaving

Bank of England policymakers in the unenviable position of setting policy to battle both weak growth and high inflation.

2. Treasury Management Strategy 2011/12

The Full Council approved the 2011/12 treasury management strategy at its meeting on 24th February 2011. The Council's stated investment priorities were:

(a) security of capital and
(b) liquidity of its investments.

The Council also aimed to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

The Council's stated borrowing strategy was to take advantage of historically low short term interest rates by borrowing short term in the money markets rather than financing capital expenditure through long term Public Works Loan Board (PWLB) loans.

The County Treasurer can report that all treasury management activity undertaken during the financial year complied with the approved strategy, the *CIPFA Code of Practice*, and the relevant legislative provisions.

3. Treasury Management Activities in 2011/12

Borrowing Activity 2011/12

The revised 2011/12 borrowing requirement was estimated at £297.433m after taking into account the updated capital programme and the refinancing of existing borrowing, including short term borrowing taken to meet the Capital Financing Requirement. The table below shows the 2011/12 revised borrowing requirement as agreed within the 2012/13 treasury management strategy report, along with the actual position as at 31st March 2012.

	2011/12 Revised £m	2011/12 Actual £m	2012/13 Estimate £m
Capital Programme Expenditure	**168.185**	**152.247**	**149.747**
Financed by:			
Capital Receipts	0	2.105	7.312
Grants and Contributions	78.239	61.847	124.020
Revenue Contributions	16.023	15.748	17.415
Borrowing	**73.923**	**72.547**	**1.000**

Add Maturing Debt to be replaced:			
Long Term PWLB	10.500	0	10.000
Short Term Market Borrowing	244.260	203.09	244.224
Less Transferred Debt	2.673	2.673	2.121
Less Statutory Charge to Revenue	28.567	28.669	24.272
Total Borrowing Requirement	**297.443**	**244.295**	**228.831**

Slightly less borrowing was required to fund new capital programme expenditure than predicted. However, of the £72.547m that was required £51.670m was funded from borrowing previously taken in advance of need in order to secure value for money, so that overall borrowing increased by £20.877m.

Analysis of Debt Outstanding

The following table sets out the structure of the County Council's debt at 31st March 2012. For clarity the figures in this table do not include accrued interest.

	Debt at 31 March 2011		**Borrowing**	**Repayments**	**Debt at 31 March 2012**	
	£m	**%**	**£m**	**£m**	**£m**	**%**
Fixed Rate Funding						
Public Works Loan Board	213.600	26.78		0.500	213.100	26.04
LOBO (RBS)	50.442	6.32	1.222		51.664	6.31
Local Bonds	0.022	0.00			0.022	0.00
Short term Market Borrowing	285.200	35.76	1,305.835	1,286.435	304.600	37.22
	549.264		**1,307.057**	**1,286.935**	**569.386**	
Variable Rate Funding						
Public Works Loan Board	195.750	24.55	0	10.000	185.750	22.70
Shared Investment Scheme	52.499	6.59	425.718	414.963	63.254	7.73
	248.249		**425.718**	**424.963**	**249.004**	
Loan Debt Administered by the County Council	**797.513**	**100.0**	**1,732.775**	**1,711.898**	**818.390**	**100**

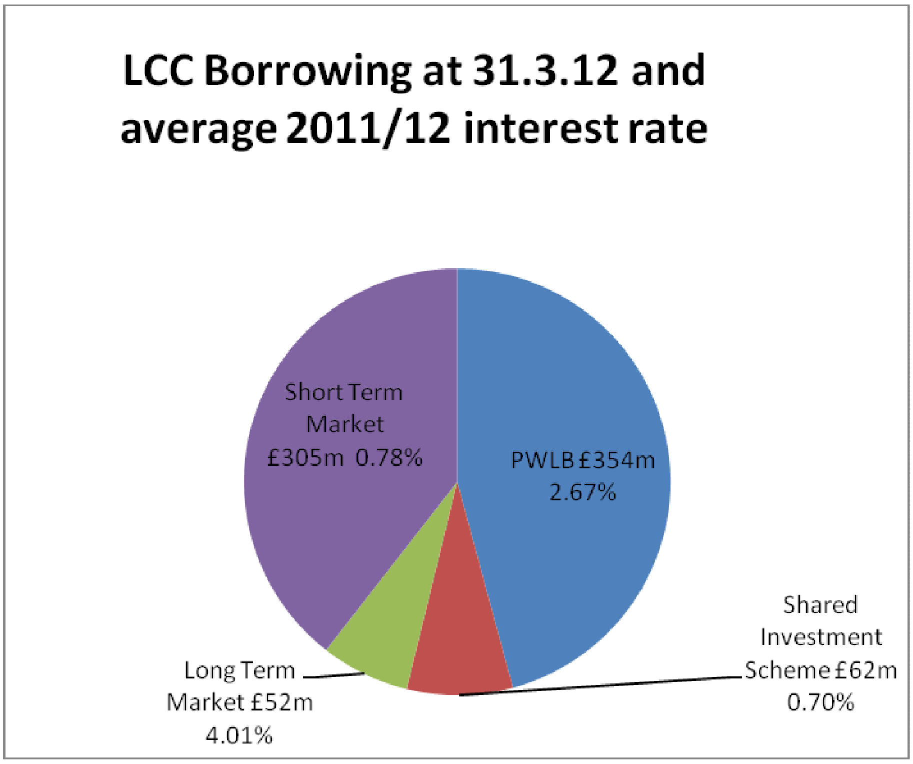
The total loan debt administered by the County Council at 31 March 2012 of £818.390m represents mainly borrowings over the years to finance the acquisition of the County Council's fixed assets, which are currently valued at £2.648 billion. However, it includes £45.227m managed by the County Council on behalf of other local authorities and the Police Authority. This debt relates to assets transferred to those authorities in local government re-organisations and the financing charges are repaid to the County Council quarterly. This leaves the net debt for which the County Council is responsible at £773.163m.

The economic background has continued to be characterised by very low short term interest rates, and market borrowing rates consistently lower than those offered by the PWLB. Consequently the County Council has continued a rolling programme of short term market borrowing to finance the current capital financing requirement as an alternative strategy of financing through long term PWLB loans

Lender Option Borrower Option (LOBO) loans are a floating rate instrument which permit the lender to nominate a revised rate at periodic dates and gives the borrower the option to accept the new rate of interest for the loan or repay the loan in full. The Council's LOBO loan has an initial 2 year fixed period (to 11th November 2012) with an interest rate of 1.65%. After the two years the rate will be calculated as 7.52% less the 10 year sterling swap rate at the time. When the loan was taken, the 10 year sterling swap rate was 3.29%, meaning the loan rate after two years would be 4.23% but if interest rates rise in the intervening period the actual rate the County Council will pay will be lower. The options built into the loan mean that after 5 years the lender has the option to amend the interest rate for the next five year period. The County Council can either accept the new rate or, if the rate is unacceptable, has the option to repay the loan in full without any penalty and end the contract. These options can be exercised every five years and overall the loan has a maturity of 50 years.

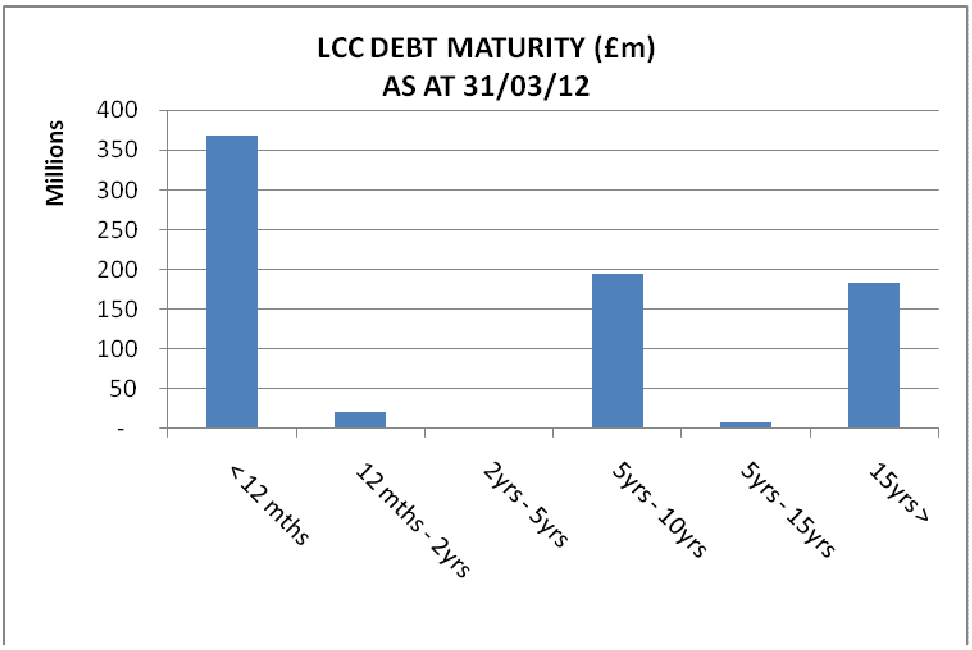
Overall the average rate of interest paid in 2011/12 on the debt administered by the County Council was 2.11% per annum compared with an average rate of 2.69% in 2010/11 and 4.37% in 2009/10.

The following chart shows the breakdown of LCC Debt and the average interest rate payable. The chart excludes debt transferred to other authorities; this has been adjusted within the PWLB total.



The current strategy of taking advantage of very low short term interest rates, whilst extremely cost effective, means that much more of the Council's debt needs to be refinanced in the short term, so exposing the portfolio to some interest rate and liquidity risk which will need to be carefully managed in the coming year.

The chart below shows the maturity profile of the County Council's debt.



There is a significant level of short term borrowing which needs to be constantly refinanced as part of the strategy to benefit from low short term rates. This gives rise to some interest rate risk, although this is mitigated by the ability of the Council to switch from short term to long term borrowing over the period during which the interest rate environment normalises, as this will be a protracted period rather than a one off event.

As part of a balanced portfolio, the risk is further mitigated by two factors:

1. Maturing and available for sale short term investments, which could, if necessary, be used to pay down debt, should it become cost effective to do so.
2. It is also mitigated by a long term £50m loan taken on a Lender Option Borrower Option (LOBO) basis. The interest rate of this loan is fixed for 2 years at 1.65% and thereafter at 7.52% less the sterling 10 year swap rate, providing an inverse relationship with interest rates - the interest payable on the loan will fall as interest rates rise.

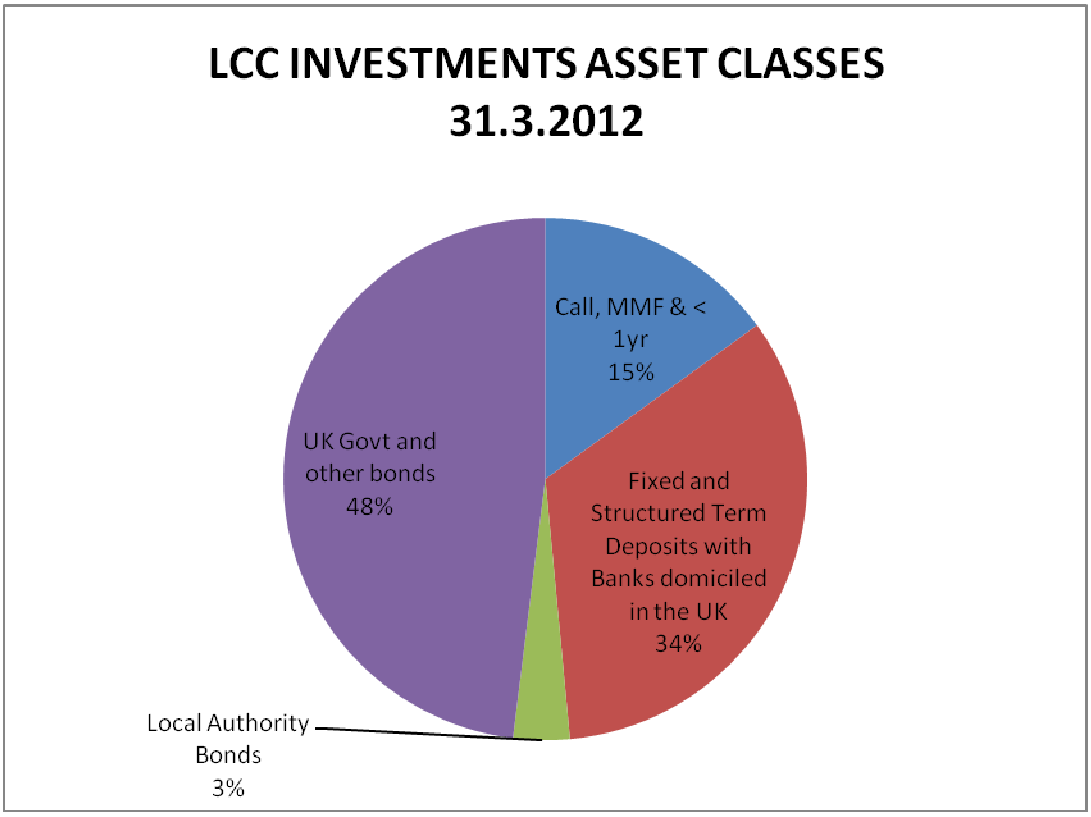
The County Treasurer will continue to closely monitor interest rate forecasts in order to establish when long term interest rates might be expected to rise. At some point, it will be beneficial to the County Council for the short term borrowing to be fixed for a longer period before long term rates rise, but current forecasts do not anticipate a rate rise in the near future.

Investment of Cash Balances

The majority of the Council's investments are now in UK Government guaranteed bonds or deposits in institutions with Government ownership/support.

Like most other councils, Lancashire has a benchmark for the average rate of interest earned on its invested cash balances. The benchmark rate is the average commercial market rate for money deposited on 7 days' notice. During 2011/12, on average, that rate was 0.48%, with Lancashire's average rate being 9.89% over the same period, reflecting the longer term deals which are still attracting a relatively high interest rate, and most significantly, the realised gains from the increase in UK Government bond prices as a result of the ongoing euro zone banking and sovereign debt crisis. Details of the way in which these exceptional gains have arisen were set out in a specific report presented to Cabinet in January 2012, available at the link below:
http://council.lancashire.gov.uk/ieListDocuments.aspx?CId=122&MId=514&Ver=4

The total amount of investments held by Lancashire County Council at 31st March 2012 is £593.16m. The table below shows the asset classes and the proportion of investments held in each class.



The table below shows a maturity analysis of the portfolio at 31st March 2012, alongside the average interest rate earned over the 2011-12 financial year.

Maturity Range	Amount £m	Average Rate %
Call, Money Market Funds & Under 1yr	88.90	1.60
Bank Deposit 1-2 Years	104.60	2.79
Bank Deposit 2-3 Years	20.00	2.43
Bank Deposit 3-5 Years	74.18	3.06
Bank Deposit 5 Years +	0	0
Local Authority Bonds	20.66	10.24
UK Government and Supranational Bonds	134.98	24.77
UK Government Index Linked Bonds	149.84	30.28
Total	**593.16**	**9.89**

4. Financing Charges Summary at the end of the 2011-12 Financial Year

The 2011/12 financing charges budget was set at £36.454m, against which the end of year position was -£19.266m representing an underspend of £55.720m. Further detail is set out in the table below:

Financing Charges 2011/12 – End of Year Position

	Budget	Year End Position	Variance
	£m	£m	£m
Minimum revenue provision	28.567	28.669	0.102
Interest paid	16.206	18.838	2.632
Investment interest received	-8.319	-66.773	-58.454
Total net financing charges	**36.454**	**-19.266**	**-55.720**

The variance above is the one reported for financial monitoring purposes. A number of further adjustments are required to the position in accordance with international financial reporting standards and these will be reported to the July meeting of the Cabinet in the report on the County Council's overall end of year financial position.

5. Treasury Management Prudential Indicators 2011/2012

The Local Government Act 2003 and supporting regulations require the County Council to have regard to the prudential code and to set prudential indicators to ensure the County Council's capital investment plans are affordable, prudent and sustainable.

A comparison of the actual position at 31 March 2012 compared to the prudential indicators set in the treasury management strategy for 2011/12 is set out below.

Treasury Management Prudential Indicators	2011/12 £M	2011/12 Actual £M
1. Adoption of CIPFA TM Code of Practice	ADOPTED	
2. Authorised limit for external debt - A prudent estimate of debt, which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements.		
Borrowing	1000	773
Other long-term liabilities(PFI schemes)	400	419
TOTAL	1400	1192
3. Operational boundary for external debt - A prudent estimate of debt, but no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of		

the County Council's current plans.		
Borrowing	950	773
Other long-term liabilities	390	419
TOTAL	1340	1192

4. Upper limit for fixed rate debt 90% 60%

5. Upper limit for variable rate debt 90% 40%

6. Upper Limit for Bank Deposits over 364 days

This limit does not apply to UK or AAA rated foreign Government or Supra National Bank securities. 75% 34%

7. Maturity structure of debt

	Lower Limit %	Upper Limit %	Actual %
Under 12 months		75	50
12 months and within 2 years		75	2
2 years and within 5 years		75	-
5 years and within 10 years		75	24
10 years and above	25	100	24

6. Audit Commission Report on the Review of Treasury Management

Members of the Committee were briefed during March on the action plan for addressing the recommendations contained in the Audit Commission's review of Treasury Management. Progress has been made against this action plan in a number of areas as indicated below:

- *Governance and Reporting*

The revised Treasury Management Policy Statement and Strategy approved by the County Council in March 2012 reflects the recommendations made by the district auditor with regard to improving the clarity of policy in a number of areas, particularly the cash backing of reserves. In addition, the prudential indicators set out in the strategy have been reviewed and recalculated to demonstrate more clearly the link to the County Council's underlying capital financing requirement.

Further work has also been done to improve the governance arrangements surrounding the operation of the County Treasurer's monthly Treasury Management Meeting, including the agreement of formal terms of reference, the formalisation of all items discussed, the development of an annual work plan and more robust performance management within the structure of the agenda. This will be further enhanced in the coming months by the transfer of support for the meeting to Democratic Services to provide more robust clerking and administration arrangements.

Work is ongoing, and will continue, to improve the format of reporting for members over the coming months. Future quarterly reports will seek to *set out how we intend to improve the reports.*

Skills and Experience
The level of skills and experience within the team continues to be enhanced. Two members of the team have completed the CIPFA/Association of Corporate Treasurers Certificate, which regrettably has been discontinued by CIPFA following this intake. One of these is now studying for the Chartered Financial Analyst qualification and the other continues to study through the ACT route. Following other staff changes it is likely that a further team member will begin undertaking a relevant qualification course at the next opportunity. In addition the recruitment process for a senior post working directly to the Chief Investment Officer will begin in the next few weeks following the successful process to appoint to two other senior posts supporting the Pension Fund which will also serve to reduce the level of single person risk in this area.

The latest member training session has recently taken place with a further session planned at the end of September. These sessions are part of an ongoing programme of training delivered by the specialist treasury management consultants Sterling Consultancy Services to ensure members are kept abreast of developments in treasury management.

Treasury management courses are also provided by treasury consultants, brokers, banks and other market participants which provide training and development opportunities for senior finance managers involved with Treasury Management activity.

Information Systems
The process for procuring a new Treasury Management System has begun, although this seems likely to take somewhat longer than initially anticipated. In the short term a process of daily reporting to senior management of compliance with the key borrowing limits has been introduced, to ensure effective monitoring of compliance with these limits.

7. Investment in Landsbanki Is.

Lancashire County Council had £6.436m on deposit with the Icelandic Bank Landsbanki Is when it collapsed in October 2008. The County Council was one of many UK and Dutch Local Authorities with such deposits, all of whom were granted priority creditor status by the Icelandic Supreme Court at a hearing in Reykjavik on 14th and 15th of September 2011. The Winding Up Board announced on 9 March 2012 that it anticipated recoveries in the Landsbanki Administration would exceed the book value of recognised priority claims by around ISK 121bn, taking into account the sale of its holding in Iceland Foods. Estimated recoveries are some 9% higher than the value of priority claims, and it is therefore now considered likely that UK local authorities will recover 100% of their deposits, subject to potential future exchange rate fluctuations.

The winding up board made its first distribution on 7th December 2011and a second distribution on 25th May 2012. Approximately 42% of the total claim has now been repaid. The table below shows the combined amount of the distributions and the amount outstanding.

	£
CLAIM	
Principal	6,435,808.29
Interest	93,384.46
TOTAL CLAIM	6,529,192.75
DISTRIBUTIONS RECEIVED TO DATE:	
Principal	2,678,448.63
Interest	38,864.66
TOTAL DISTRIBUTIONS	2,717,313.29
CLAIM OUTSTANDING	3,811,879.46

The exact timing and amounts of future distributions is not known at this stage.