Appendix A

Update on Treasury Management activity

Background

This is the latest report on the conduct of the Council's Treasury Management activities which allows the Audit Committee to exercise its responsibilities for oversight of this area of the Council's business. Reports on treasury activity are discussed on a monthly basis with the Executive Director for Resources and the content of these reports is used as a basis for this report to the Committee.

Economic Overview

Much of the detail around fiscal tightening has now been announced but little has actually been introduced yet so it is a little early to gauge the likely results in terms of the interest rate landscape and the effects on the UK economy at large.

It is likely that changes in taxation, in particular VAT, will continue to put short term pressure on inflation and that in combination with general fiscal tightening the consumer is likely to remain under strain. Discretionary spending should be most at risk. Wage freezes and redundancies in the public sector may be offset by increased activity in private industry but relative impacts of these two opposing forces will take time to evaluate. Although headline inflation will certainly remain high for the near future leading some to call for an increase in interest rates, recent poor employment and average earnings data suggests the Monetary Policy Committee (MPC) will resist the increase until the recovery is more evident in the economic data.

The sensitivity of the UK economy as a whole to interest rate movements is larger now than previously and consequently we believe the Bank of England will be very cautious in shifting monetary policy. The Governor of the Bank has made it clear that the current high levels of inflation are likely to be transitory and that fiscal tightness and the output gap will most likely bring this over shoot down in the medium term. In fact the Monetary Policy Committee is still very nervous that deflation could be the outcome of government policy combined with world events (core inflation excluding tax changes is well below the 2% CPI target). The MPC is aware that periods of deflation are much more difficult for monetary authorities to deal with than inflation.

Economic data has remained mixed overall, although in recent weeks data has generally been more supportive of the recovery thesis but as little of the announced fiscal tightening has take effect yet, caution is still advised.

The major market risks currently come from two sources:

- Sovereign credit issues especially around peripheral Europe and the impact of these on the banking systems in Europe
- Global trade, growth and currency imbalances; Emerging World growth is being heavily relied on by the developed world and many bellicose noises are being made on currency values with hints of trade protectionism

Should either of these issues develop badly then the risks to the whole markets are very large.

Major Developments

On the same day as the Comprehensive Spending Review, the Treasury announced that, with immediate effect, the Public Works Loans Board would increase the cost of loans to Authorities by an average of 1.00% per annum across all maturities, whilst retaining its draconian early repayment penalty charge (now 1.33% per annum). This change will lead to a fundamental re-appraisal of Local Government capital financing.

The intention of the Government is clearly that there should be a very significant reduction in the overall level of local authority "self financed" capital expenditure (i.e. expenditure financed by means other than grant). In addition this move creates a push for Authorities to fund either in the capital markets or the money markets, or a combination of the two. The capital markets are most appropriate for larger authorities given that they are most likely to be able to deal with the required size of issuance and professionalism of approach. There is, however, a very large **BUT;** in order to properly manage such a process and the concomitant risks, Authorities will need to have access to a number of tools not currently used by Local Government.

This move has the potential to add further costs to local authority borrowing. However, although funding through the capital markets may add further layers of complexity and difficulty to the treasury management function it also could present many opportunities to improve performance and reduce costs.

At the same time as PWLB rates became uneconomic; the traditional banking alternatives have evaporated. Changes to bank's funding and reserve cost regimes have made it either prohibitively expensive to lend or regulatorally impossible. Therefore the capital markets are the likely solution for Local Authorities and the County Council is actively developing plans in this area in order to minimise future costs and risks, whilst at the same time maximising opportunities. There is substantial demand in the UK for Sterling denominated bond issues in either long dated (over 30yrs) fixed rate or index linked format, but such deals will need to fulfil certain requirements,

- Local Authorities will need to be credit rated by at least one of the two main agencies (Moodys, or Standard and Poor).
- Institutional investors need to have the confidence that they can buy and realise their investment easily and this depends upon the market being able to absorb the supply and demand that their positions generate. For this reason bond issues in Sterling will need to be above a critical size to qualify as liquid (£150m minimum.) and therefore give institutional investors the confidence needed.
- Bonds will need to be issued via special purpose vehicles for tax reasons.
- A strong group of market makers will need to be involved in the issuance of such bonds in order to provide buyers with the liquidity they need. Market makers quote bid and offer prices (ie make a market) for securities and crucially are prepared and able to buy or sell those securities at any time on

their own account, so ensuring that prices and buying and selling opportunities are always available to investors.

There will also be good demand for Local Authority bonds issued in other currencies and in other formats (hedged back into Sterling) with the added benefit that such issues will not need to be so large.

The best mechanism for such issuance will be in the form of a Medium Term Note (EMTN) programme, a coverall documentation that allows for multiple issuances of bonds without the need to repeat legal and contractual work and under which various type of debt and currency instruments can be created. In the past each time an issuer came to the market to raise funds a separate set of legal documents would be produced, new legal and listing opinions sought (and paid for). The development of the EMTN mechanism (an ongoing listing and legal framework) was driven by the need to streamline and simplify the legal process. It is now the norm for any borrower who is likely to raise debt more than once over the period of a few years. The single route is still available but completely inflexible.

Similar programmes for money market issuance can be created, Commercial Paper Programme (ECP) which will allow for access to short term cash held by corporation and money funds, these institutions are still concerned about credit risk with much of the European banking system but will only lend to rated institutions via formalized programmes.. This will reduce the Council's reliance on bank funding or loans from other Authorities.

The Treasury Management team will engage the Moodys credit rating agency with a view to acquiring both short and long term credit ratings, the indicated ratings are P1 (top short term rating) and Aaa (top long term rating). If these ratings are achieved the next step will be to negotiate the construction of EMTN and ECP programmes with a group market makers.

Advisory Services

The current contract with Sector Treasury Services is due to be re-tendered and in light of the above mentioned opportunities to change our approach to capital financing, an area in which Sector have very limited expertise, timing for such an exercise is propitious. We are preparing documentation in conjunction with the procurement team with a view to seeking an enhance quality and scope of service, while also allowing other Council's in Lancashire to access the services provided under the contract as part of the shared services agenda. It is intended that the new contract will begin in early May. In the meantime a 6 month contract extension has been agreed with Sector.

Local District Councils

The Audit Commission and CLG reports following the Icelandic Banking Crisis both highlighted the particular problems District Councils face in their treasury management activities. In order to gain an acceptable rate of interest they need to go to the market with a sizeable sum for investment. Due to the size of the overall

budget, this would represent a large proportion of the available balances and therefore an unacceptable credit risk.

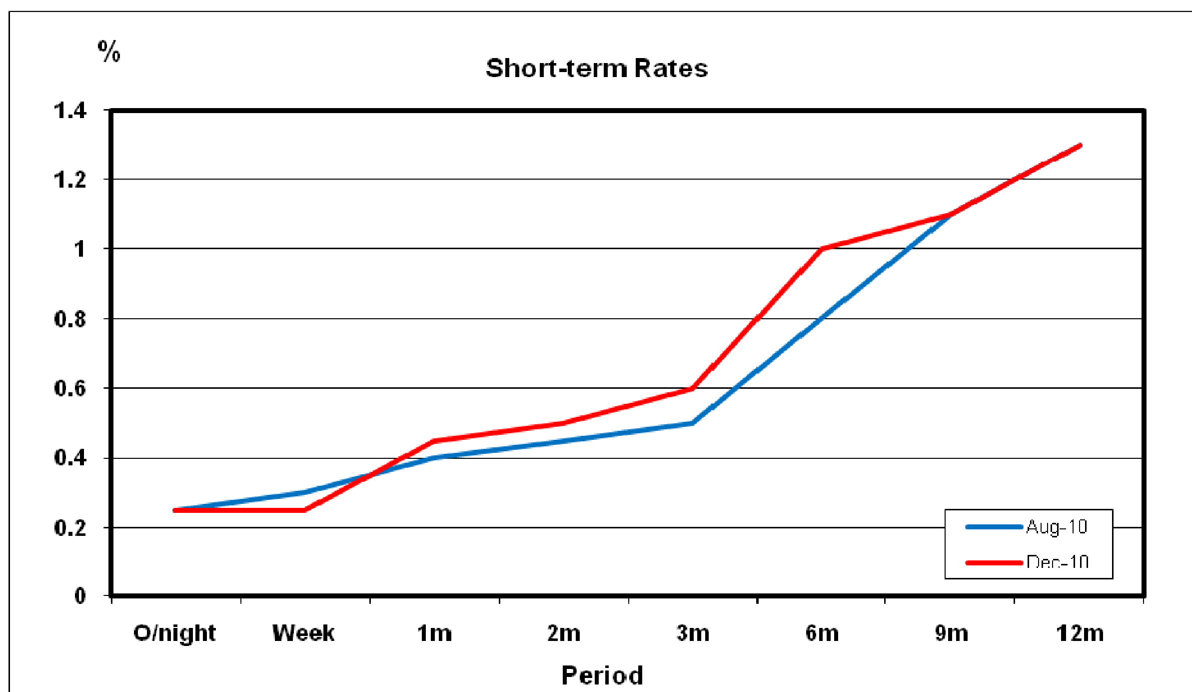
In response to this and as part of the shared service agenda, the County Council offers an investment opportunity on a call account basis to the Lancashire Districts with a view to reducing their counterparty risk whilst still providing a good level of interest. The facility was opened in mid June 2010 and to date 10 Districts have taken advantage with funds totalling to £36m. The benefit to the Districts is that they have earned approximately twice as much interest on their balances compared with the UK Government's Debt Management Account whilst maintaining a comparable very low credit risk.

In conjunction with the call deposit the Treasury Management Team also provides a fixed deposit facility enabling local Authorities to invest funds for a longer period of time.

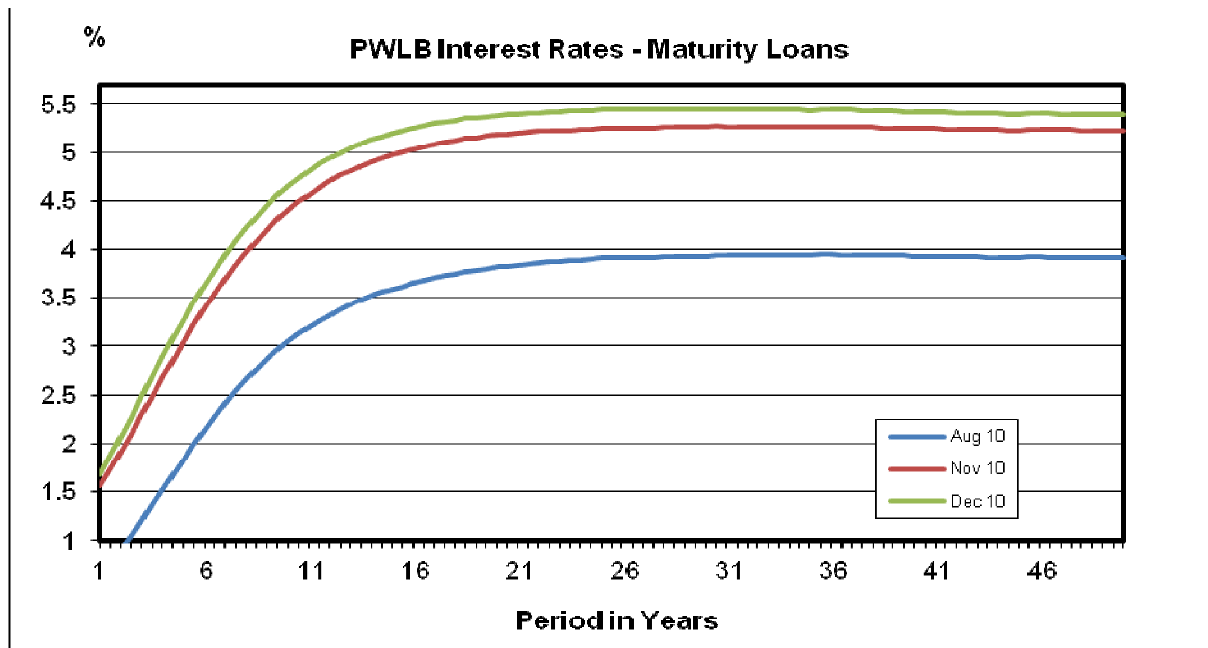
In both cases the funds invested count against the County Council's overall borrowing requirement.

Borrowing and Investments

Short term interest rates continue at the very low levels since the Bank of England reduced the base rate to 0.5% in March 2009. The chart below shows the current levels.



Current longer term PWLB rates are shown below:



The current PWLB rates and revised forecast of interest rates, published recently, are as follows:

Economic Forecasts – Sector Treasury

November 2010

	End Q4 2010	End Q1 2011	End Q2 2011	End Q3 2011	End Q4 2011	End Q1 2012	End Q2 2012	End Q3 2012
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%
5yr PWLB rate	3.00%	3.00%	3.10%	3.20%	3.30%	3.50%	3.80%	4.10%
10yr PWLB rate	4.10%	4.10%	4.10%	4.20%	4.30%	4.40%	4.60%	4.80%
25yr PWLB rate	5.00%	5.10%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%
50yr PWLB rate	5.10%	5.20%	5.30%	5.40%	5.40%	5.50%	5.50%	5.50%

Economic Forecasts – Capital Economics

November 2010

	End Q4 2010	End Q1 2011	End Q2 2011	End Q3 2011	End Q4 2011	End Q1 2012	End Q2 2012
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
10yr PWLB rate	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%
25yr PWLB rate	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%	4.80%
50yr PWLB rate	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%

Economic Forecasts – UBS

November 2010

	End Q4 2010	End Q1 2011	End Q2 2011	End Q3 2011	End Q4 2011	End Q1 2012	End Q2 2012
Bank Rate	0.50%	0.50%	0.50%	0.75%	1.00%	N/A	N/A
10yr PWLB rate	4.00%	4.10%	4.30%	4.50%	4.60%	N/A	N/A
25yr PWLB rate	5.10%	5.10%	5.10%	5.20%	5.30%	N/A	N/A
50yr PWLB rate	5.10%	5.20%	5.20%	5.30%	5.40%	N/A	N/A

Borrowing activity

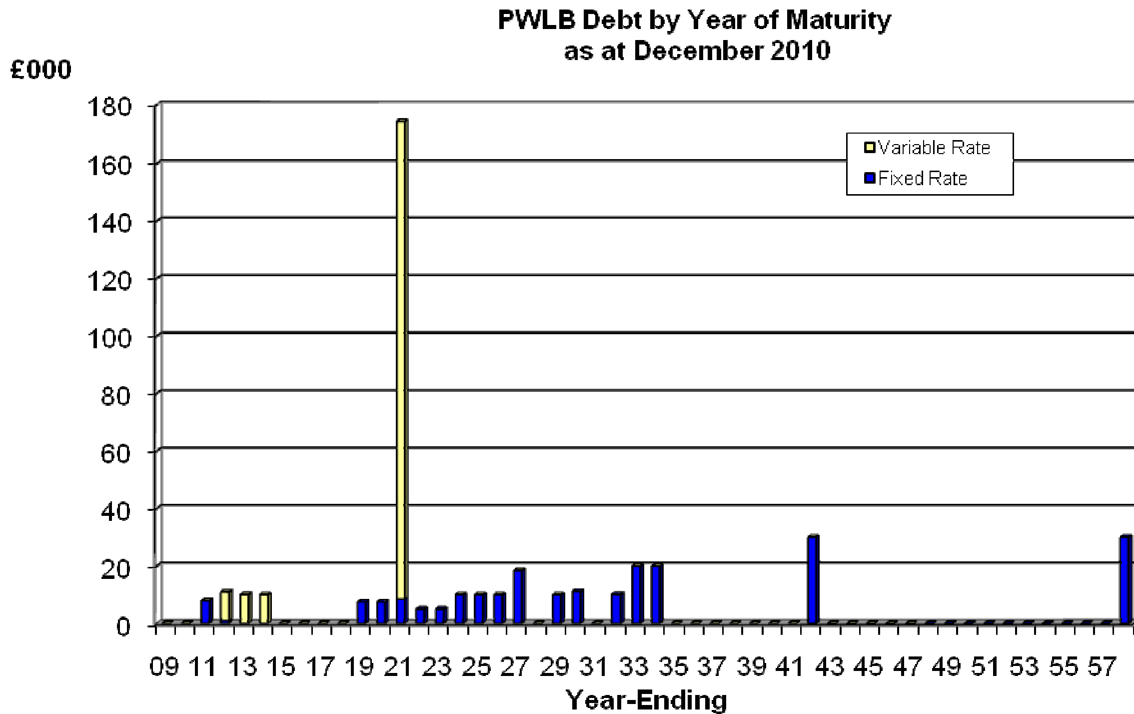
The actual 2009-10 borrowing position compared with the estimate based on the revised capital program is shown in the following table:

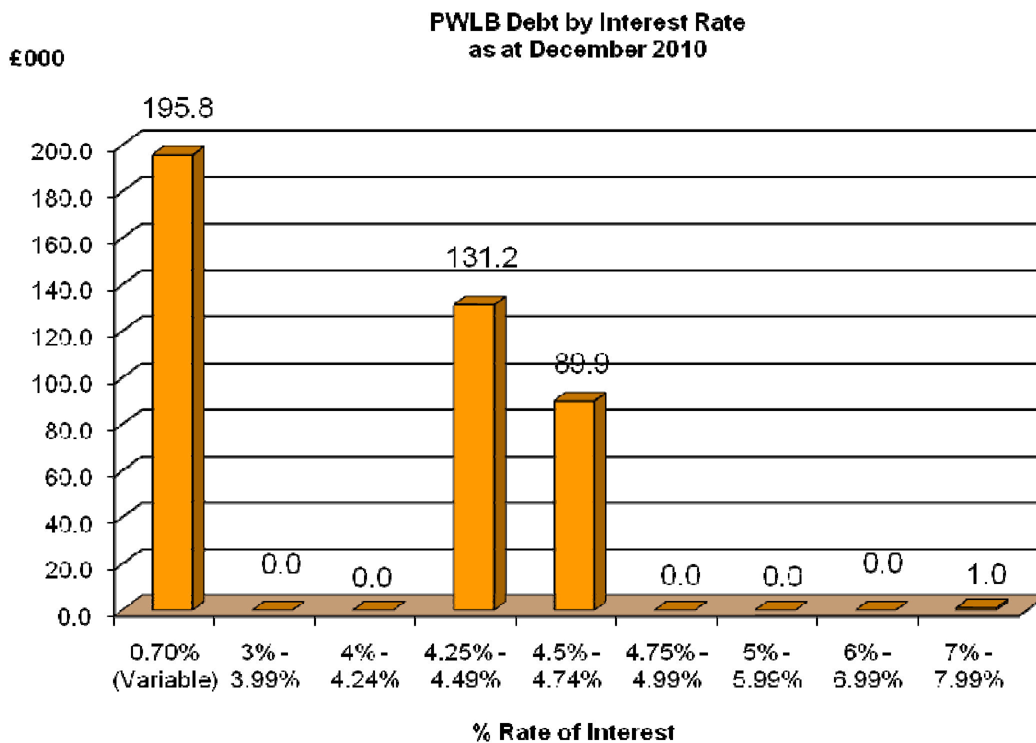
	2009-10 Estimate £000	2009-10 ACTUAL £000	2010-11 Estimate £000	2011-12 Estimate £000
Supported Borrowing	54,214	43,627	39,814	27,900
Unsupported Borrowing	44,998	21,335	41,136	42,714
Maturing Long Term Debt	15,029	15,029	9,029	20,514
Less transferred debt repayments	-4,069	-4,069	-4,069	-4,069
Less Minimum Revenue Provision	-21,175	-22,465	-24,272	-26,339
Less advance borrowing brought forward from previous years	-17,459	-17,459	-10,000	
Total requirement 2009/10	**71,538**	**35,998**	51,638	60,720
Actual short term borrowing 09-10		**98,000**		
Actual long term borrowing 09-10		**10,000**		

The 2009/10 borrowing requirement stands at £35.998m after taking into account the advance borrowings brought forward from 2008/09 and the decisions taken by Cabinet in September 2009 in respect of switching revenue contributions to the capital programme to prudential borrowing. This is less than initially anticipated due to slippage in the Capital Programme and the application of grants rather than anticipated borrowing on the BSF project.

The policy in place since investment rates have been falling has been to use internal cash balances in lieu of borrowing to fund capital expenditure, as this had been the least expensive option, but recently short term borrowings from the market have become cheaper than "self funding", consequently in order to secure the Authority's liquidity position £108m has been borrowed from other Local Authorities with a range of short maturities from 9months to 15months at an average cost of 0.65%. Our view is that UK rates will stay low for longer than the market expects and that longer rates will fall from current levels – should this view be confirmed we will refinance accordingly.

The following graphs highlight the interest rates payable on the County Council's long term PWLB borrowings along with the maturity profile.





During the period we have taken £50m of long term finance (50yr maturity with calls each 5yrs) in structured format such that if 10yr rates rise the cost of this borrowing falls proportionately. This was a risk management decision, to diversify our interest rate sensitivity exposure.

Investments

Following the formal approval of the revised investment policy at Council on 17th December 2009, the County Council is now operating a credit de-risking strategy using information from the credit default swap market in addition to credit ratings to assess counterparty reliability and by increasing our exposure to sovereign credit at the expense of bank risk.

It has been our view since the beginning of 2010 that market expectations of early and sharp rises in base rate were too aggressive and that the steepness of the forward interest rate curve would have to be pegged back. We have continued to express this view via purchases of government, government guaranteed and supranational bonds as well as looking to more closely match our reserve characteristics.

With the current financial instruments available to Local Government, it is impossible to fully protect a portfolio against inflation and interest rate increases whilst at the same time providing a reasonable return in the present. Without access to the derivatives market, to be able to respond quickly to changes in the environment, investments must be highly liquid; if interest rates rise investments can be switched quickly to take advantage of the higher rates. However, liquidity is expensive and to access reasonable rates in the present environment investment maturities must be pushed out and liquidity given up. One of the tasks of the Treasury Management Section is to balance these two conflicting risks. As a partial offset to hedge against a rising inflation environment we have made purchases of inflation linked bonds issued by European Investment Bank (AAA) and Network Rail (UK govt guaranteed bonds). These bonds perform well in high inflation environments since although the coupon payments are fixed, the principal repayment is index linked as long as they are held to maturity. However the value of the bonds rises and falls depending on the markets view of future inflation expectations.

Strategic Medium Term Investments under New Treasury Management Policy

Maturity Range	Amount £M	Average Rate
1-2 Years	3.00	1.60%
2-3 Years	167.60	2.92%
3-5 Years	25.00	3.30%
Local Authority Bonds	28.00	4.84%
Bonds	113.00	3.70%
Index Linked Bonds	87.40	5.05%
Totals	424.00	3.71%

In terms of credit risk, the Local Authority Bond portfolio along with the Bonds and Index linked bonds are all either UK Government or Supra-national (ie Multi- national Investment Bank) backed securities. The majority of the rest of the portfolio is made up of bank deposits with UK Government owned banks. The only other institutions with which the County Council has funds with a maturity period longer than overnight are Barclays and Santander Banks.

For the portfolio overall this represents a much reduced credit risk compared with the previous policy.

One of the items on the Treasury team's workplan for 2011 is to look into formal models of risk management.

Landsbanki

At the time the Icelandic banks collapsed in October 2008, the County Council had an investment of £10.0m with Landsbanki.

In November 2009 the Landsbanki Winding Up Committee confirmed that wholesale depositors, including local authority deposits, would be treated as preferential creditors within the administration process. This decision was expected and was the basis of estimates that creditors could expect an eventual payout of around 83p in the pound. However, the Winding Up Committee of another Icelandic bank, Glitnir, later decided the wholesale depositors were not preferential creditors in their administration process. At this moment in time there is no direct connection between the Glitnir and Landsbanki decisions but clearly they are inconsistent. Both decisions have been appealed, and if the Landsbanki decision is overturned, the County Council can expect a much lower return from the administration process, current estimates vary between 23 - 27p in the pound. The appeals process continues with the Authority being represented by the Local Government Association and legal advisors Bevan Brittan. Currently all information is subject to legal privilege due to commercial confidentiality and although there is considerable uncertainty around the expected date of a conclusion to the appeals process the committee will be kept informed of developments.

Recommendation

The Committee is asked to note the above report on treasury activity.