Appendix A

Audit Committee 27th June 2011
Quarterly update and Review of Treasury Management 2010/11

Introduction

In February 2010 the Council adopted the 2009 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, a mid year report, and an annual report after the end of each financial year. This report is the annual report for the 2010/11 financial year.

1. The Economy and Interest Rates in 2010/11

Following recession in 2009, global economic activity rebounded in 2010. Traditional exporters like Germany benefited from rising consumer demand worldwide, although economies more reliant on domestic consumption, including the UK, faced a weaker outlook. The government and household sectors of these countries were burdened by excessive debt, ultimately resulting in weaker domestic spending.

The absence of a quick economic recovery led to rising government budget deficits, especially in the European periphery, and prompted some concern among bond investors and credit rating agencies. This loss of confidence in the ability of some governments to repay their debts saw bond yields rise and the markets effectively closed to certain countries. Greece, Ireland and Portugal were all forced to seek financial assistance from the European Union and the International Monetary Fund.

The UK's deteriorating financial position was also a concern. The UK had the highest budget deficit in the EU in 2009/10 and the economic outlook was weak. However, the new Conservative-Liberal Democrat coalition government, formed following the General Election in May 2010, outlined what was perceived by investors and credit rating agencies to be a credible fiscal consolidation plan. With financial problems continuing elsewhere in Europe, the UK was perceived to be a relative "safe haven", and strong appetite for UK government debt kept gilt yields low.

While the UK government focused on tightening fiscal policy, the Bank of England maintained loose monetary policy. Bank Rate remained at 0.5% throughout the financial year, despite inflation rising to over double the 2% target as the price of, largely imported, raw materials increased. With inflation expected to test 5% during 2011, the risk that raised inflation expectations would feed into wages and prices was increased, three members of the Monetary Policy Committee voted for an increase in Bank Rate in February. The remaining six members, however, were more concerned that higher interest rates could choke off the economic recovery, which was already showing signs of slowing in response to fiscal tightening. The MPC remains divided on when to raise Bank Rate, although the market expectation is for an increase this autumn.

2. Treasury Management Activities in 2010/11

Borrowing Activity 2010/11

The 2010/11 borrowing requirement was originally estimated at £51.638m after taking into account the advance borrowings brought forward from 2009/10 and the decisions taken by Cabinet in September 2010 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. The outturn position to compare against this estimate was £52.340m, however the actual amount of borrowing activity undertaken has been markedly increased by two debt restructuring exercises during the 2010/11 financial year.

The actual 2010/11 borrowing position compared with the estimate based on the revised capital program is shown in the following table:

	2010-11 Estimate £000	2010-11 ACTUAL £000	2011-12 Estimate £000	2012-13 Estimate £000
Supported Borrowing	39,814	40,512	0	0
Unsupported Borrowing	41,136	29,964	42,714	22,624
Maturing Long Term Debt	9,029	19,022	10,500	10,000
Less transferred debt repayments	-4,069	-3,007	-3,000	-3,000
Less Minimum Revenue Provision	-24,272	-24,151	-28,567	-30,540
Less advance borrowing brought forward from previous years	-10,000	-10,000	-65,840	-
Total borrowing requirement	**51,638**	**52,340**	-44,193	-916
Repaid Long Term Debt		**292,781**		
Actual short term borrowing 10-11		-194,769		
Actual long term borrowing 10-11		-216,192		
Borrowing carried forward to 11-12		**-65,840**		
Short term debt replacement			**150,576**	**149,660**

During the year the Treasury Management Team undertook a debt restructuring exercise, taking advantage of very low short term interest rates by replacing relatively expensive long term PWLB debt with short term market debt. The resulting increase in borrowing activity is shown in the table above below the capital financing borrowing requirement. At some point the short dated borrowing will be replaced by longer maturities but the timing of this depends on the shape of the yield curve and the availability of market borrowing. The UK Treasury's decision as part of the Comprehensive Spending Review to introduce a 1% spread above gilts for PWLB pricing means it is very unlikely future borrowing will be sourced from the PWLB. The short term debt replacement estimates for 2011/12 and 2012/13 assume current market conditions will continue, but obviously this situation may change depending on the above factors, and the position will be kept under review and reported to Members as necessary.

Analysis of Debt Outstanding and Average Interest Rates

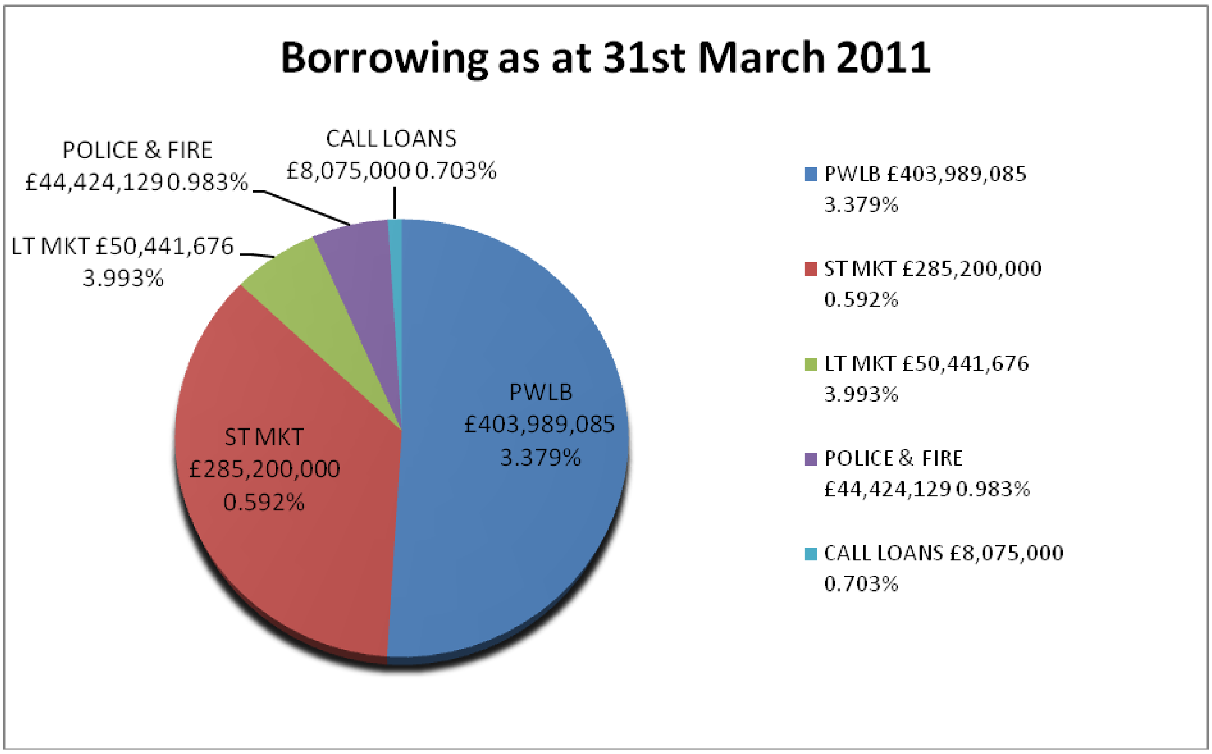
The following table sets out the structure of the County Council's debt at 31st March 2011. The figures in this table are calculated on the basis required by International Financial Reporting Standards and the 2010 position has been adjusted accordingly.

	Debt at 31 March 2010 Restated		**Borrowing**	**Repayments**	**Debt at 31 March 2011**	
	£m	**%**	**£m**	**£m**	**£m**	**%**
Fixed Rate Funding						
Public Works Loan Board	510.020	78.70		301.803	208.217	78.70
LOBO (RBS)	0.000		50.650	0.208	50.442	
Local Bonds	0.022				0.022	
Short term Market Borrowing	108.000	16.67	1,149.695	972.495	285.200	16.67
	618.042		**1,200.345**	**1,274.506**	**543.881**	
Variable Rate Funding						
Public Works Loan Board	30.000	4.63	165.750	-	195.750	4.63
District Call Loans Facility	0.00		57.430	49.355	8.075	
Police and Fire Authorities	35.286		319.973	310.835	44.424	
	65.286		**543.153**	**360.190**	**248.249**	
Loan Debt Administered by the County Council	**683.328**	**100**	**1,743.498**	**1,643.696**	**792.130**	**100**

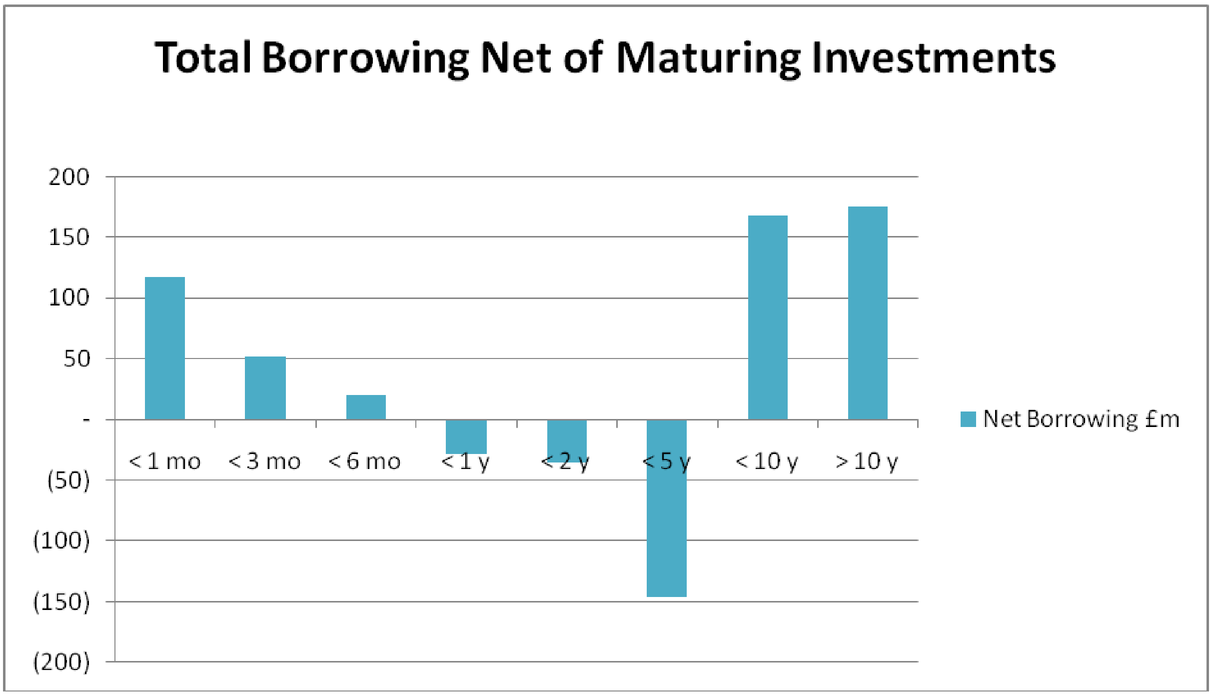
The total loan debt administered by the County Council at 31 March 2011 of £792.130m represents mainly borrowings over the years to finance the acquisition of the County Council's fixed assets, which are currently valued at £2.437 billion. However, it includes £47.900m managed by the County Council on 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.

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

The following chart shows the breakdown of LCC Debt and the average interest rate payable on the different type of instruments.



The debt restructure has also brought about a significant change to the maturity profile of the County Council's debt. Much more of the debt will need to be refinanced in the short term and this leaves the portfolio exposed to some interest rate risk which will need to be carefully managed in the coming year.
The chart below shows the net refinancing risk, that is borrowing less maturing investments.



It can be seen that there is a large level of short term borrowing which needs to be constantly refinanced as part of the strategy to benefit from low short term rates, and it is this which gives rise to the interest rate risk, nevertheless, the risk is partly mitigated by maturing short term investments.

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.

Impact of the above year end position on the approach to borrowing in 2011/12.

A revised forecast of interest rates, published recently by our treasury management advisors Sterling Consultancy Services is shown below. Note that the Quarter and Half years referred to are calendar (as opposed to financial) years.

Interest Rate Forecast May 2011

	SCS Central forecast					Market forecast	
	Bank Rate	*1 month LIBOR*	*3 month LIBOR*	*12 month LIBOR*	*25 year PWLB*	*Bank Rate*	*3 month LIBOR*
Current	0.50	0.63	0.83	1.59	5.17	0.50	0.83
Q2 2011	0.50	0.65	0.85	1.60	5.30	0.53	0.84
Q3 2011	0.75	0.85	1.00	1.85	5.40	0.58	0.92
Q4 2011	1.00	1.10	1.25	2.10	5.50	0.68	1.03
Q1 2012	1.25	1.35	1.50	2.40	5.60	0.83	1.17
Q2 2012	1.50	1.60	2.00	2.90	5.70	0.99	1.35
H2 2012	2.00	2.10	2.50	3.50	5.80	1.37	1.79
H1 2013	2.75	2.85	3.25	4.40	5.90		2.21
H2 2013	3.50	3.60	4.00	5.00	6.00		2.66

Forecasting Future rates has become an exercise in quantifying the MPCs willingness to look through current short term inflation spikes in applying its "controlling future inflation on a 2yr horizon" mandate. Expert opinion remains divided, the slight majority calling a path of small 25bp rises beginning in August taking base rate from the current 0.50% to 2.0% over the course of the next 18mths, whilst a number of strategists see the economy still being too fragile to deal with simultaneous fiscal and monetary tightening and therefore rate rises being unlikely until mid to late 2012. On balance the Treasury management view is in the later camp.

There is a similar dislocation of views on longer term rates between the camp calling for higher long term rates required to maintain investor demand for government debt and others who see continued foreign demand for UK debt as a "safe haven" from turmoil in peripheral Europe and Pension Fund liability hedging demand. Given the scale of the Pension liability problem in the UK (and the rest of developed markets) we are in the later camp. UK Pension Fund Liability potential demand is in excess of £1.5 trillion (ie. million million) compared to UK annual gilt issuance of £165bn.

UK forward interest rate curves are still forecasting higher rates, so even if we do see a series of rate rises the market has already discounted such moves..

Investment of Cash Balances
Following the formal approval of the revised investment policy at Full 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. Whilst our ability to express this view is limited by the financial instruments available to us we have continued to add to our 2-5yr deposit portfolio as a good approximation of the view.

The team have progressed with the construction of the "4 portfolio" approach outlined in the Treasury Management Policy 2009. We now have all portfolios populated and the de-risking policy has been fully implemented. The majority of the Council's investments are now in Government or 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 2010/11, on average, that rate was 0.431%, with Lancashire's average rate being 2.453% over the same period, reflecting the longer term nature of the portfolio.

At the 31st March 2011 the interest rate on the portfolio was 3.43%. The table below provides an analysis.

Maturity Range	Amount £m	Average Rate %
Call, MMF & Under 1yr	83.96	1.58
1-2 Years	67.65	3.07
2-3 Years	106.31	2.79
3-5 Years	75.45	4.62
5 Years +	5.89	4.54
Local Authority Bonds	20.79	4.71
Bonds	60.72	3.71
Index Linked Bonds	61.59	5.35
Totals	**482.36**	**3.43**

Operation of arrangements with other bodies (District Councils, Fire and Police Authorities and Pension Fund)

During 2010/11 there have been a number of changes to the accounting treatment of transactions undertaken on behalf of other bodies.

The Lancashire County Pension Fund as a result of a regulatory change has established it's own banking arrangements and consequently the cash funds previous placed by the Fund with LCC now will now be place directly with market counterparties in line with the specific LCPF treasury management policy approved by the Pension Committee in April 2011.

Funds accepted from District Councils and the Fire and Police Authorities now form part of LCC's capital financing programme and as such are categorized as "Call borrowing programmes" and accounted for in the same way as other short term borrowing. While this change creates some transitional issues in the consistent presentation of information in the longer term it provides greater transparency to these arrangements which are beneficial to all parties.

Financing Charges Year end Out-turn Summary 2010-11

The 2010 -11 financing charges budget was set at £46,487m, against which the outturn was £31,294m representing an underspend of £15.193m.

Financing Charges 2010/11 Outturn Figures	**budget**	**out-turn**	**variance**
	£000	£000	£000
Minimum rev provision	26,460	23,984	-2,476
Interest paid	25,187	20,074	-5,113
Investment interest received	-4,704	-12,323	-7,619
Grants received	-456	-441	15
Total net financing charges	**46,487**	**31,294**	**-15,193**

Treasury Management Consultants

It had been over five years since the County Council invited tenders for the TM Consultancy contract and therefore all relevant market participants were put on notice of an upcoming tender process in October 2010. Tenders were formally invited in February for a new contract to begin on 1st April 2011 and accordingly Sterling Consultants (SCS) were appointed to the contract.

Treasury Management Prudential Indicators 2010/2011

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 2011 compared to the prudential indicators set in the treasury management strategy for 2010/11 and with revised indicators agreed by cabinet on 4th November 2010, is set out below.

The indicators were revised during the year to take account of the fact that in the interests of transparency, monies held on behalf of the Police and Fire Authority, previously netted off cash in the accounts, would in future be shown as borrowing. Secondly in undertaking the debt restructure programme and switching secure (but expensive) long term borrowing to much cheaper short term borrowing, the Authority must have maintained enough liquidity to meet its day to day financial obligations and it is important to keep credit streams open.

At the peak of the restructure programme in January the Authority breached, for a short time, the authorised external debt limit. This was rectified immediately by reducing the level of short term borrowing.

In addition the revised indicators did not take account of Private Finance Initiative assets coming back onto the balance sheet under IFRS accounting and it is this that accounts for the breeching of the operational and authorised boundaries for other long term debt. As PFI liabilities are not direct borrowing by the Council this is a technical rather than a fundamental issue, nevertheless a full review of the Authority's prudential indicators will be undertaken in the near future and all changes presented to members for approval.

Treasury Management Prudential Indicators	**2010/11 Original £M**	**2010/11 Revised £M**	**2010/11 Actual £M**
1. Adoption of the CIPFA Code of Practice for Treasury Management	This has been fully 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	780	1000	792
Other long-term liabilities(eg leases)	5	5	191
TOTAL	785	1005	983
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	745	950	792
	Other long-term liabilities	3	3	191
	TOTAL	748	953	983
4.	**Upper limit for fixed interest rate debt**	780	800	544
5.	**Upper limit for variable rate debt**	390	600	248
	The limits shown at 4 and 5 above are consistent with current practice and reflect prudent levels in the current economic climate.			
6.	**Upper limit for total principal sums invested for over 364 days** (per original period to maturity):	150	-	-
	For UK and Overseas AAA rated banks:	-	500	
	For UK Nationalised and Part Nationalised Banks and UK Local Authorities	-	300	
	UK or AAA rated foreign Government or Supra-national Bank Securities and UK Local Authority Bonds.	75% OF TOTAL PORTFOLIO		

7. Maturity structure of debt

	Upper/Lower Limit % 2010/11 Revised	Upper/Lower Limit % 2010/11 Actual
Under 12 Months	75 / 0	36
12 months and within 2 years	75 / 0	1
2 years and within 5 years	75 / 0	1
5 years and within 10 years	100 / 25	19
10 years and within 15 years	100 / 25	4
Maturing after 15 years	100 / 25	39

Investment in Icelandic Banks

Lancashire County Council had £6.436m on deposit with the Icelandic Bank Landsbanki Is when it collapsed in October 2008. At the time the winding up committee decided that wholesale depositors, such as local authorities, were preferential creditors, meaning that they would be amongst the first claims to be paid distributions from the winding up of the company. This decision makes a great deal of difference to the amount of the claim against the assets of the bank which the Authority can expect to receive. Due to the sums involved the decision was challenged through the Icelandic courts by vulture funds and other non-preferential creditors.

The case was heard on 14-18 February in Reykjavik and the decision passed down by the judge on 1st April. The Icelandic District Court found in favour of local authorities and ruled that deposits placed by UK wholesale depositors have priority status in the winding up of the Icelandic banks. Subsequently an appeal to the Supreme Court has been made and a final decision is expected in September 2011. No indication has been given as yet to the timing of any distributions.

Based on the current statement of assets and liabilities of the bank the most up to date indications are that Authority will recover 94.85% of the value of the claim (CIPFA May 2011) although this figure is wholly dependent on realisations made from the assets of the bank and may change.

In terms of accounting treatment, since the collapse in 2008-09 the Icelandic deposit has been treated as an impaired asset, with the value of the asset written down to reflect the potential loss and this has been charged to the general fund. In 2008-09 and 2009-10 the Authority took advantage of a special capital financing regulation, which enabled the Authority to defer the impact on the general fund by transferring the impairment to the financial instruments adjustment account. It has always been the case that the regulation would last for two years and that the impairment transfer to the financial instruments adjustment account would be reversed in 2010/11.

In accordance with legislation and CIPFA accounting guidance, all transactions relating to the Landsbanki investment transferred to the financial instruments adjustment account in previous years have now been reversed, and an impairment charge of £1.285m made to the 2010-11 Accounts. In addition and also in accordance with recommended accounting practice £0.308m of notional interest has been credited to the investment interest account. In total this reflects an assumption that 94.85% of the Council's total claim will be paid.