**Appendix A**

## Update on Treasury Management activity

### Background

At the meeting of Cabinet on 9 July 2009, it was agreed that in order to strengthen members' oversight of the County Council's treasury management activities, the Audit Committee should receive regular updates on treasury management issues and that members of the Audit Committee should receive more detailed training in order to enable effective oversight of the County Council's treasury management activities. In addition compliance with the CIPFA Treasury Management code of practice requires a mid-year treasury activity report and therefore this report focuses on events over the first six months of the 2011-12 financial year.

Reports on treasury activity are discussed on a monthly basis with the County Treasurer and the content of these reports is used as a basis for this report to the Committee.

### Economic Overview

Over the last six months, the outlook for the world economy, and that of the UK, has deteriorated. According to the OECD, growth across its thirty-four members has now slowed for four consecutive quarters. Essentially the underlying issues are:

- Unsustainable debt levels in both the personal and public sectors in many countries including the UK.
- An unsustainable medium term debt and deficit position in the US.
- The emergence of serious sovereign debt problems focussed on Ireland, Greece, Portugal, and possibly Spain and Italy.
- A process of de-leveraging by governments, households and banks in several countries, at a time when major economies are weak and vulnerable. Never before have so many countries been adopting large-scale fiscal retrenchment simultaneously.
- There is substantial dispute amongst both politicians and economists about what the appropriate policy response should be.
- This is compounded by the additional problem that governments are running out of policy instruments, with interest rates at record low levels and budget constraints severely limiting the scope for fiscal policy to respond to weakness in the economy.
- In many countries banks remain fragile, not least because of their exposure to sovereign debt. There has recently been a re-emergence of funding difficulties for some banks which, over the next year or so, will need to re-finance on a large scale as past borrowings come to maturity.

This is such a problematic set of circumstances that we are clearly not dealing with a conventional recession and its aftermath. All indicators are pointing to an 'austerity trap', which will see low growth rates and declining living standards for the next few years to come.

**Interest Rate Forecasts**

The analysis above and the Bank of England Monetary Policy Committee (MPC) response to date would indicate that the current policy stance is likely to persist for some time to come. At the August MPC meeting the members voted 9-0 to keep rates at 0.5% and subsequently all commentators pushed the likelihood of an increase in bank rate further into the future.

Long term interest rates remain extremely difficult to predict in these highly uncertain times. While current levels of gilt yields are not justified by recent inflation performance, turmoil in the Europe and the US Debt ceiling arguments and ratings downgrade has generated exceptional demand for safe-haven investments, and it is likely that yields will remain under downward pressure while the threat of sovereign defaults and economic stagnation persist.

The forecast below is provided by Professor David Llewellyn consultant economist at the international broking company ICAP plc.

It can be seen that, in common with many market commentators, the expectation of a bank rate increase has now been pushed out to March 2013.

| Year | End Period | Bank Rate | Money Rates (BBA LIBOR) | | PWLB Rates | | |
|---|---|---|---|---|---|---|---|
| | | | 3 mth | 12 mth | 5yr | 20 yr | 50 yr |
| 2011 | Mar | 0.50 | 0.8 | 1.7 | 4.2 | 5.4 | 5.3 |
| | Jun | 0.50 | 0.8 | 1.6 | 3.3 | 5.2 | 5.2 |
| | *Aug-26* | *0.50* | *0.8* | *1.6* | *2.6* | *4.6* | *4.7* |
| | Sep | 0.50 | 0.8 | 1.6 | 2.5 | 4.6 | 4.7 |
| | Dec | 0.50 | 0.8 | 1.6 | 2.5 | 4.7 | 4.8 |
| 2012 | Mar | 0.50 | 0.8 | 1.6 | 2.6 | 4.8 | 4.9 |
| | Jun | 0.50 | 0.8 | 1.7 | 2.9 | 5.0 | 5.2 |
| | Sep | 0.50 | 0.8 | 1.7 | 3.1 | 5.2 | 5.4 |
| | Dec | 0.50 | 0.8 | 1.8 | 3.3 | 5.4 | 5.5 |
| 2013 | Mar | 0.75 | 0.9 | 2.0 | 3.5 | 5.5 | 5.5 |

Clearly the positioning of the portfolio to anticipate low interest rates for an extended period seems an appropriate position at the current time.

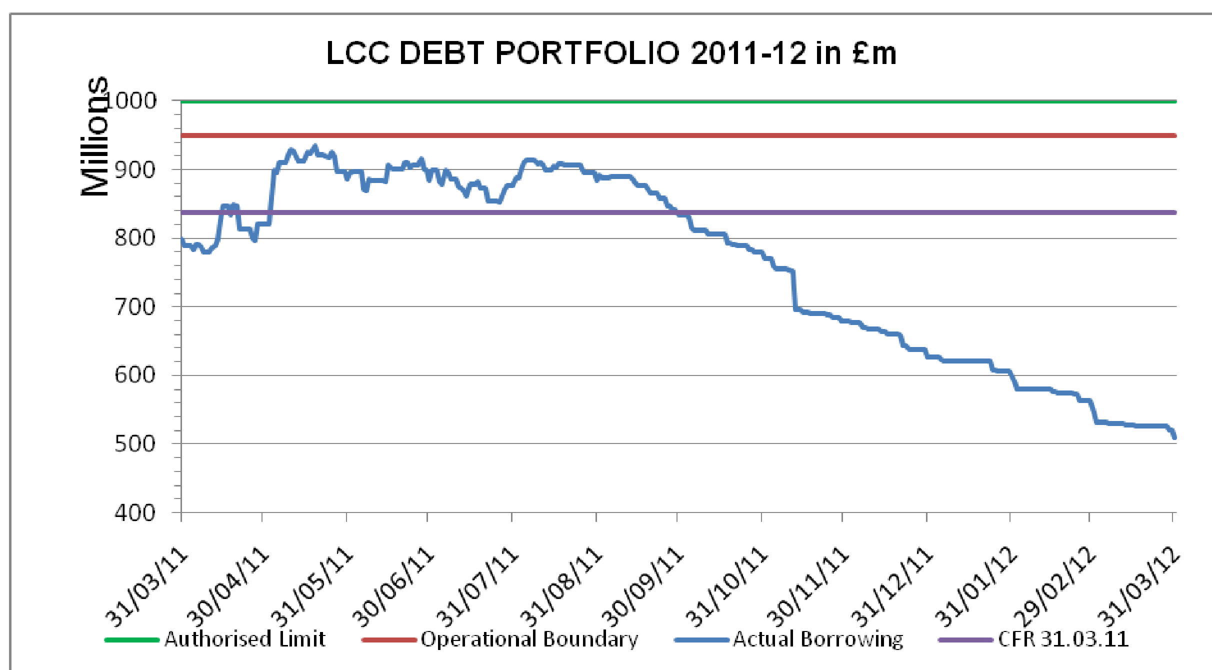
The risk to the current portfolio is that once the euro-zone crisis passes its peak and demand for safe haven instruments slackens the markets should see a rebalancing

of yields and a rise in longer term rates towards levels more in keeping with a positive inflation environment.

**Borrowing**

Current market conditions continue to enable the County Council to take advantage of short term market borrowing following the repayment of £293m of long term fixed debt in 2010.

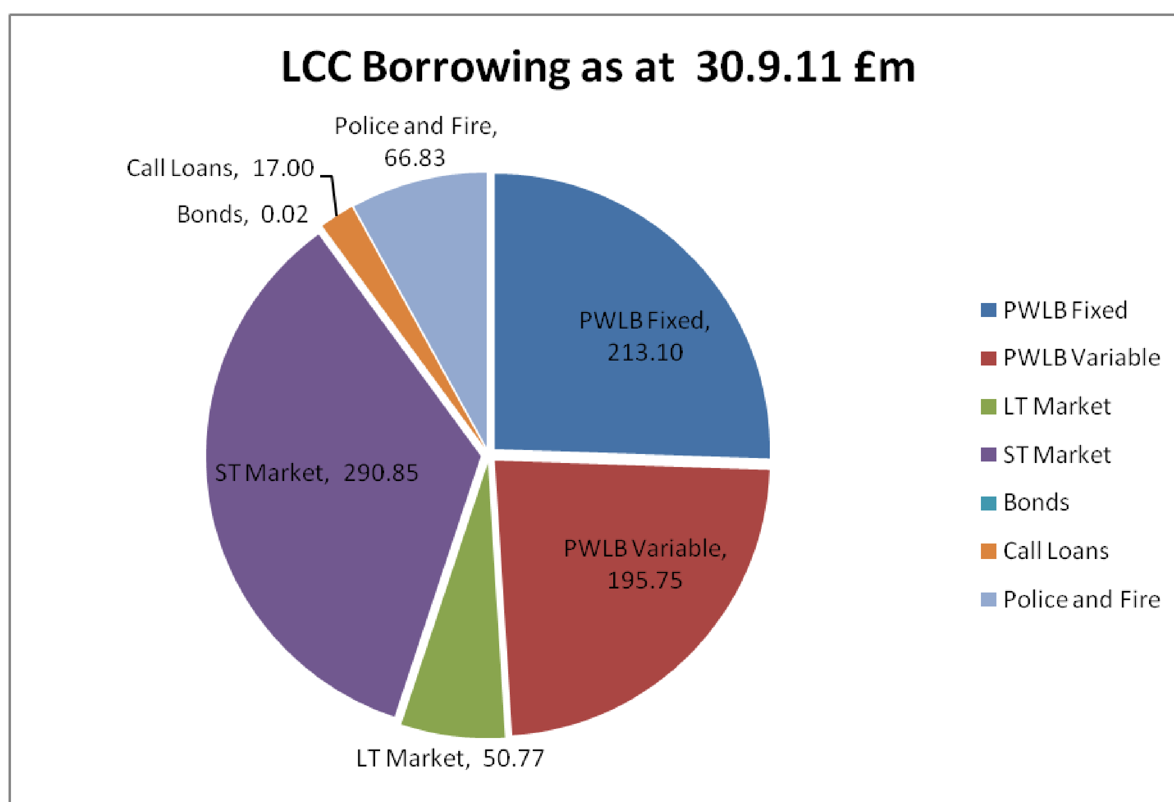
The chart below shows the actual level of total debt over the first half of the year and because a large part of the total is short term market borrowing it can be seen how quickly the level of borrowing falls if maturities are not replaced.
The chart also shows that borrowing has been contained within the operational boundary, set as part of the prudential indicators within the current treasury management strategy.




Also included on the chart is the capital financing requirement (CFR) valued as at 31 March 2011. The CFR is the element of the County's fixed assets not yet financed, either by charging the expenditure to revenue through the minimum revenue provision or by some other method such as applying capital receipts.

The actual level of borrowing may temporarily rise above or fall below this level due to day to day cash flow management and portfolio management processes, but overall we would expect borrowing to be around about this level. When the borrowing total is below CFR, as it was at 31st March, LCC are 'borrowing internally' or funding capital expenditure from cash flow balances. The short term borrowing strategy is working very well at the moment and we will be looking to renew or replace most of the borrowing which is maturing around the end of September.

The pie chart below shows the proportions of the various types of borrowing within the portfolio.




The latest estimate of borrowing activity for the 2011-12 financial year is shown in the table below. The debt restructure undertaken during 2010-11enabled the County Council to take advantage of current very low short term interest rates. However it does mean that the County is more active in the short term money market. The level of short term borrowing which needs to be replaced in the current financial year, based on the latest capital programme estimates, is £150.576m as shown in the table below.

| | 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 |
| Maturing Short Term Debt | | | 194,769 | 150,576 |
| Less transferred debt repayments | -4,069 | -3,007 | -3,000 | -3,000 |
| Less Minimum Revenue Provision | -24,272 | -24,151 | -28,567 | -26,339 |
| Less advance borrowing brought forward from previous years | -10,000 | -10,000 | -65,840 | |
| Total borrowing requirement | **51,638** | **52,340** | **150,576** | 149,660 |
| 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** | | |

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 Public Works Loan Board (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.

**Investments**

Stresses in the European financial markets, in particular the potential effects on the global banking system and the reduction in interbank liquidity, have lead the Treasury Management team to actively reduce the bank exposure of the Council, emphasising strongly the security of capital ahead of return. We have cut limits for banks and where possible deposits have been withdrawn. Resultant cash has been invested in UK Gilts, Government guaranteed and AAA supranational bonds denominated in sterling. We have also strategically reduced our index linked holdings as we see a risk of deflation ahead.

Having pre-empted the market moves by a month or so the prices paid for these bonds are low compared to current values, so whilst the rationale for the re-allocation was fund security the net effect is both a substantial reduction in credit risk and a simultaneous increase in returns and capital values.

This credit risk reduction strategy will stay in place as long as the sense of heightened risk remains in the markets. At the moment we see a limited prospect of a successful solution being developed by regulators and policy makers in the short term and believe that it is likely that risks and volatility will continue to increase.

Our view is that these events will keep policy rates at extremely low levels for much longer than the market in general had expected (at least until 2013) and that further policy measures will be enacted by the Bank of England, either a reduction in base rate to US/Swiss levels (i.e. "close to zero"), introduction of "QE2" or structural changes to longer yields – or in extremis all three weapons may be used. The portfolio level effects should be a lowering of long term rates ("flattening of the yield curve") a reduction in inflation expectations and thence the value of index linked securities. Consequently we have established a maturity balanced portfolio via UK Gilts.

Credit risk (the risk that individual counterparties will default on contractual payment obligations) is monitored very closely by the Treasury Management team. The current assessment of the financial environment is such that only a small number of

very high quality banks and their subsidiaries remain on the LCC counterparty lending list. They are:

| BANK | SOVEREIGN DOMAIN | INFORMATION |
|---|---|---|
| Lloyds TSB | **UK** | **UK Government Guarantee** |
| RBS | **UK** | **UK Government Guarantee** |
| HSBC | **UK** | **AA credit rating, CDS price implied AAA rating** |
| OCBC | **Singapore** | **A+ credit rating, CDS price implied AAA rating** |
| DBS | **Singapore** | **AA- credit rating, CDS price implied AAA rating** |
| Rabobank | **Netherlands** | **AAA credit rating, CDS price implied AAA rating** |
| Svenska Handlesbanken | **Sweden** | **AA- credit rating, CDS implied AAA rating** |

In the past six months LCC have made only one fixed term bank deposit, a renewal of a £30m 4 month deposit with OCBC.

The overall investment portfolio is currently structured as follows:

Call (instant access) accounts 12%
Bank deposits with maturities > 2 years 15% (all UK Govt guaranteed banks)
Bank deposits maturing between 6 months and 2 years 25% (all UK banks)
Bank deposits maturing within 6 months 5%
Bank deposits maturing within 3 months 7%
UK Government Guaranteed Bonds 22%
Supra-national Bonds 14%

In the current environment any bank deposit would be restricted to a maximum of 3 month maturity. In addition due diligence is being conducted on a number of money market funds which would provide a mechanism to reduce exposure to the banking system for funds held as call deposits.

**Revenue Budget Monitoring**

The financing charges budget has been set at £37.125m for 2010/11. The current forecast year end position is £33.435m, a surplus of £3.689m against the budget.

**Landsbanki**

An appeal to the Icelandic Supreme Court has been lodged by Landsbanki's non-priority creditors to overturn the decisions of the Winding Up Board and the District Court in recognising the British and Dutch local authorities as priority creditors. The hearing will be heard on 14th and 15th September and a final decision is expected within one month. If the Supreme Court upholds the District Court judgement local authorities can expect to recover up to 98 per cent of the deposit.

**Recommendation**

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