Appendix A

Treasury Management Activity Mid-Year Report 2012-13

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. 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.

This report considers treasury management activity over the first 5 months of the financial year.

Economic Overview

Despite some stronger economic growth data towards the end of 2012, consumers are yet to loosen their purse strings and businesses are still reticent to make long-term investment decisions. The momentum in GDP growth is therefore unlikely to be sustained while uncertainty over the economic outlook persists. Consumer Price Inflation has fallen close to the Bank of England's 2% target, although it is expected to be affected by volatility in energy and commodity prices throughout 2013.

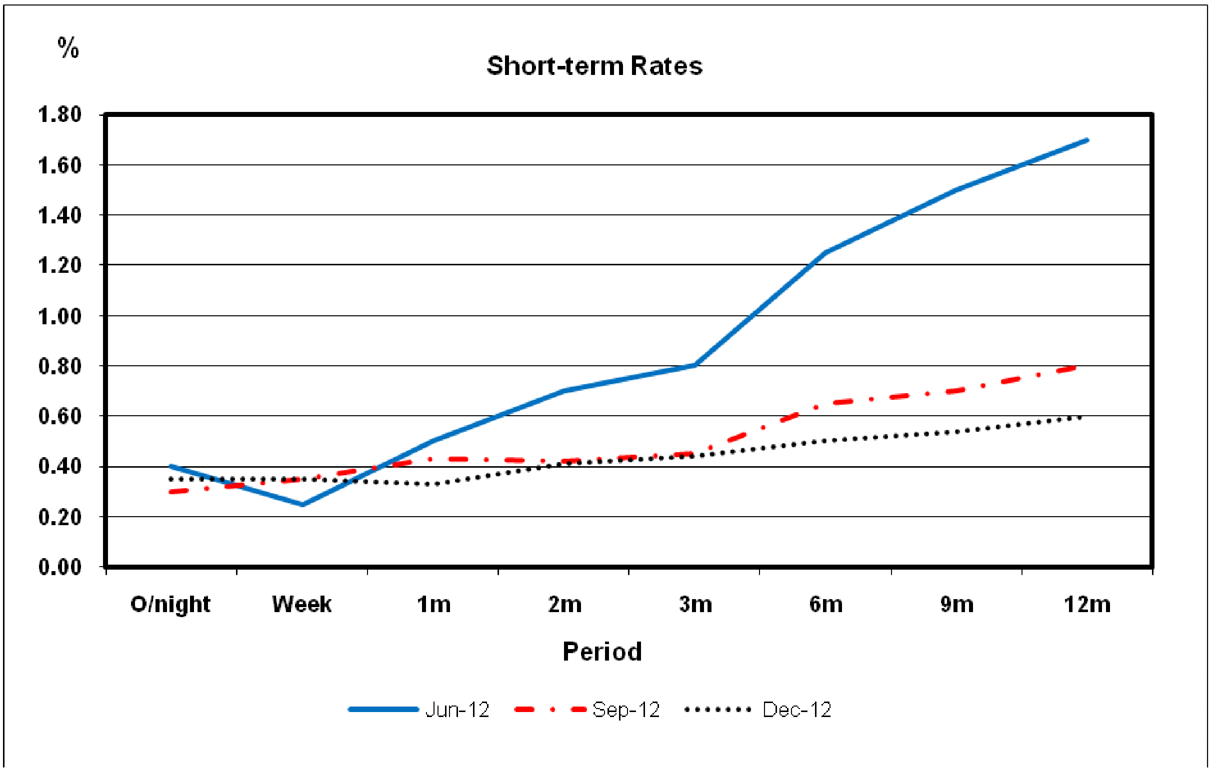
Having voted to increase quantitative easing by £50bn in July, the Bank's Monetary Policy Committee is waiting to assess the effectiveness of the Funding for Lending Scheme that started in August. Further asset purchases remain a distinct possibility, although there is a developing consensus that quantitative easing is becoming less effective.

The US Federal Reserve has responded to the slowdown in growth and employment with large scale asset purchases of $40bn a month until the outlook for the labour market improves substantially. The US public finance 'fiscal cliff' nevertheless remains a serious risk unless a political solution is reached soon.

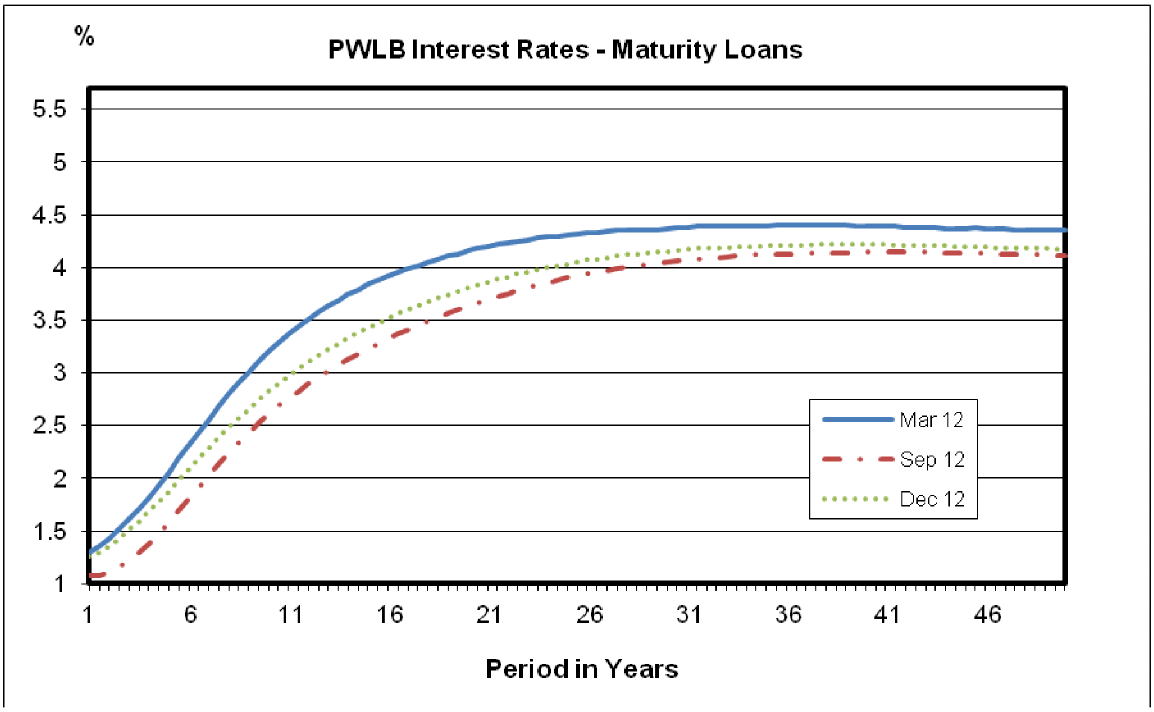
The Eurozone is making slow headway, with the European Stability Mechanism now operational, announcements on the Outright Monetary Transactions programme well received, and some progress being made towards banking union. These have placated markets and curtailed some of the immediate risks to the stability of the monetary union. A sustainable solution to the Eurozone crisis is some way off though, as fiscal integration and mutualisation of Eurozone sovereign debt liabilities remain politically unpalatable.

Interest Rate Environment

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



Current longer term PWLB rates are shown below.



During the summer uncertainty in world markets has increased the demand for UK government debt which puts downward pressure on UK interest rates. The effects of this can be seen in the fall of the PWLB rates in the period. The shape of the curve has remained constant with rates much lower at the short end.

Outlook for Interest Rates

Arlingclose Limited, the County Council's treasury management adviser, are predicting that it could be 2016 before official UK interest rates rise. The US Federal Reserve has signalled it will keep interest rates "at exceptionally low levels" until at least 2015, and with the UK's safe haven status and minimal prospect of short-term rate rises, gilt yields are expected to remain near their current lows.

Arlingclose central interest rate forecast – November 2012

	Bank Rate	3 month LIBID	12 month LIBID	20-year gilt yield*
Current	0.50	0.40	1.09	2.71
Q4 2012	0.50	0.55	1.10	2.80
Q1 2013	0.50	0.55	1.10	2.80
Q2 2013	0.50	0.60	1.25	2.80
Q3 2013	0.50	0.60	1.25	2.80
Q4 2013	0.50	0.60	1.25	2.80
H1 2014	0.50	0.70	1.40	2.90
H2 2014	0.50	0.75	1.40	2.90
H1 2015	0.50	0.75	1.40	3.00
H2 2015	0.50	0.75	1.40	3.00

* The Council can currently borrow from the PWLB at 0.80% above gilt yields

Current Treasury Management Policy

Historically, the Council's investment portfolio, like that of many local authorities, had consisted almost entirely of fixed term deposits with very short maturity periods, and borrowing was provided entirely through PWLB loans with long dated maturities This served the Authority well during a decade of consistent economic growth, low inflation and a stable economic environment where the County Council could consistently invest balances at a higher return than the cost of borrowing. However in 2007 the collapse of the banking system and subsequent world recession ended this benign financial environment.

The current borrowing policy of keeping a higher proportion of borrowing at variable rates or short dated maturities is enabling the County Council to take advantage of the very low rates available on short term borrowing. In addition, given that the current pressure on rates is still downwards, it positions the County Council to take advantage of any further falls in longer term rates in the near future.

The current investment policy of accessing high credit quality institutions through bond investments as opposed to placing fixed term deposits directly with banks continues to be the County Council's preferred strategy given the continued difficult credit environment.

The County Council identifies sub-portfolios into which the overall investment portfolio is divided, broadly reflecting the County Council's overall cash position and profile of when balances are required. From this position it is possible to provide geographical and financial sector diversity, whilst increasing liquidity and credit quality management. Inflation and interest rate risk can also be managed and there is a possibility of increased investment returns if suitable opportunities arise.

The sub-portfolios include:

- **Bond liquidity book** made up of short dated gilt edged securities, commercial bonds, treasury bills, short date sovereign (UK government) and supra-national bonds (i.e. bonds from institutes such as the EBRD). All these instruments can be bought or sold at very short notice. This sub portfolio is for the management of day to day cash flows.

- **Bank liquidity book** made up of call accounts, short dated bank deposits, bank certificates of deposit, money market funds, reverse repurchase agreements, again to manage daily cash flows.

- **Core Maturity matching book** for medium term and less volatile reserves. These instruments can be matched to the expected cash flows pertaining to reserves which will be held over a longer period. This will compromise gilt edged securities, Sovereign and Sovereign Guaranteed Bonds, Supra national bonds, Local Authorities bonds/debt and Bond funds. Possibly longer term bank deposits with institutions of very high credit quality. A significant proportion of this portfolio will still be highly liquid, principally to afford the ability to react to changing circumstances.

- **Core cash book** for longer term investments. This can be used to provide a higher yield on cash which the Authority can lend for longer periods – investments would include structured deposit/certificates of deposit/Notes short/medium term maturities with capital protection.

- **Specific situation book** – index linked gilts or bonds, structured deposits and certificates of deposit. This portfolio will be tailored to specific requirements as they arise, examples might include PFI reserves.

A table outlining the types of financial instruments to be held within these portfolios and how they are accounted for is included at Appendix B.

Investment Activity

The table below shows investment activity during September to November 2012

Bank Deposits

	Call	Fixed	Structured	Total
	£m	£m	£m	£m
Balance 1st September	**16.51**	**129.60**	**124.18**	**270.29**
Maturities	(476.74)	-	-	(476.74)
New Investments	477.14	-	-	477.14
Balance 30th November	**16.91**	**129.60**	**124.18**	**270.69**

Bonds

	Local Authority Bonds	UK Govt Gilts	Corporate & Supra-nationals	Total
	£m	£m	£m	£m
Balance 1st September	**37.91**	**178.90**	**86.39**	**303.20**
Maturities	-	(126.05)	(148.31)	(274.36)
New Investments	-	95.77	193.43	289.20
Balance 30th November	**37.91**	**148.62**	**131.51**	**318.04**

Overall the level of investments has remained fairly static with some realignment made between the UK gilt and corporate bond portfolios.

Borrowing Activity

Current market conditions continue to enable the County Council to take advantage of short term market borrowing. The table below shows the borrowing activity which has taken place between September and the end of November 2012. The total is net of transferred debt.

	PWLB Fixed Rate £m	PWLB Variable Rate £m	Long Term Market Loan £m	Other Locals £m	Police, Fire and Lancashire District Councils £m	TOTAL £m
Balance 1st September	**168.30**	**125.75**	**52.32**	**279.50**	**94.65**	**720.52**
Maturities	-	-	-	(98.10)	(85.39)	(183.49)
New Borrowing	-	-	-	113.04	78.62	191.66
Balance 30th November	**168.30**	**125.75**	**52.32**	**294.44**	**87.58**	**728.69**

The total borrowing level changes daily depending on the County Council's cash flow position, but overall there has been no significant change in the total level of borrowing during the period.

Prudential Indicators

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 31st August 2012 compared to the prudential indicators set in the treasury management strategy for 2012/13 is set out below.

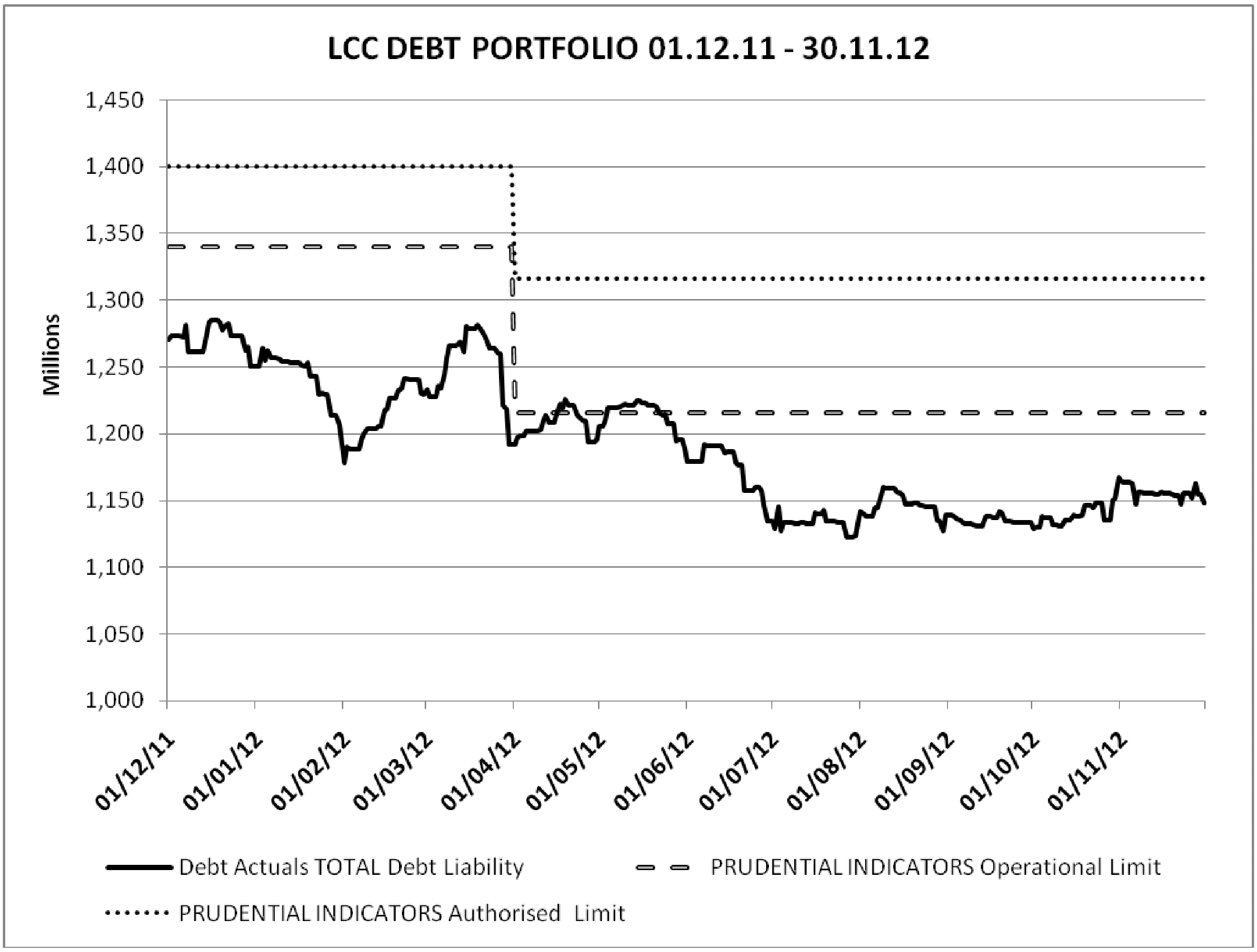
Treasury Management Prudential Indicators	**2012/13** **£M**	**30th Nov Actual** **£M**
1. Adoption of CIPFA TM Code of Practice	ADOPTED	
2. Authorised limit for external debt - A prudent estimate of debt, which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements.		
Borrowing	791	729
Other long-term liabilities(PFI schemes)	525	419
TOTAL	1316	1148
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	741	729

Other long-term liabilities	475	419
TOTAL	1216	1148

4. Maturity structure of debt

	Lower Limit %	Upper Limit %	Actual %
Under 12 months		75	52.43
12 months and within 2 years		75	-
2 years and within 5 years		75	-
5 years and within 10 years		75	21.15
10 years and above	25	100	26.42

The graph below shows the level of total debt for each day of the past calendar year compared with the prudential indicator operational and authorised boundaries.



Budget Monitoring Position

	Cash Limit	Est Actual	Variance
	£m	£m	£m
MRP	25.996	25.996	-
Interest Paid	20.720	18.000	(2.720)
Interest Received	(11.309)	(18.589)	(7.280)
Grants	(0.403)	(0.403)	-
	35.004	25.004	(10.000)

Current Projections indicate a £10m under- spend against the financing charges budget.
This position can change taking account both of ongoing performance and also market movements as is kept under regular review and an updated forecast is provided to the County Treasurer on a monthly basis.

Icelandic Banks

At the time the Icelandic banks collapsed in October 2008, the County Council had an investment of £10.0m with Landsbanki. Under the treasury management strategy in operation at that time, the County Council's share of the deposit was £6.436m.

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 2011, the second distribution on 25th May 2012 and the 3rd distribution on 9th October 2012. Approximately 48% of the total claim has now been repaid. The table below shows the combined amount of the distributions and the amount outstanding.

<u>CLAIM</u>	£
Principal	6,435,808.29
Interest	93,384.46
Total	**6,529,192.75**
Received	3,098,465.33
Claim outstanding	3,430,727.42