Sunderland City Council

Item No. 10

AUDIT AND GOVERNANCE COMMITTEE **22 March 2013**

TREASURY MANAGEMENT UPDATE

Report of the Executive Director of Commercial and Corporate Services

1. Purpose of Report

1.1 To report on a downgrade in UK Sovereign Credit Rating by Moody's Investors Service credit rating agency on 22nd February 2013 and implications of this change to the Council.

2. Description of Decision

2.1 To endorse the record of decision made under delegated powers and associated amendments to the Lending List Criteria and Approved Lending List set out in Appendix A.

3. Introduction

3.1 This report sets out details of the recent downgrade in the UK Sovereign Credit Rating by Moody's Investors Service, the implications of this change to the Council and steps that have been taken to update the Council's Lending List Criteria and Approved Lending List following this downgrade.

4. UK Sovereign Credit Rating

4.1 On 22nd February 2013 Moody's Investors Service downgraded the Sovereign Rating of the United Kingdom by one notch from Aaa to Aa1 due to

- The continuing weakness in the UK's medium-term growth outlook with a period of low growth that Moody's now expects will extend into the second half of the decade
- The challenge this weakness poses to the government's fiscal consolidation programme, which will now extend well into the next parliament term
- And, as a consequence of the UK's high and rising debt burden, a deterioration in the capacity of the government's balance sheet to withstand financial shocks that is unlikely to reverse before 2016.

Moody's also placed the UK Government on stable outlook which means that no further movement in the rating is anticipated over the next 12 to 18 months and reflects the expectation that political will and medium-term fundamental economic strengths will, in time, allow the Government to implement its fiscal consolidation plan. Moody's noted that the UK's creditworthiness remains extremely high and that the UK has significant credit strengths.

Including
- A highly competitive, well-diversified economy
- A strong track record of fiscal consolidation and a robust international structure, and
- A favourable debt structure, with supportive domestic demand for government debt, the longest average maturity structure of debt (15 years) amongst all highly rated sovereign countries globally and the resulting reduced interest rate on UK debt

The stable Aa1 rating is still very good, reflecting that whilst the UK's debt-servicing capacity remains very strong and very capable of withstanding further adverse economic and financial shocks, it does not at present possess the extraordinary resilience common to other AAA rated sovereign bodies. Following the financial downturn over the last few years only 11 countries globally still hold an AAA rating with all of the three main ratings agencies.

The other two credit ratings agencies, Fitch and Standard and Poors, still currently rate the UK at AAA, although their ratings are expected to be reviewed within the next few months.

5. Implications

5.1 The investment limits that Sunderland City Council hold with UK financial institutions has been reliant on the UK sovereign credit rating remaining at AAA. Whilst this rating has reduced to an AA+ level it is felt that investments made with UK financial institutions remain low risk and should be maintained at current levels.

This can be highlighted by the minimal reaction shown by the financial markets to the downgrade. Usually a rate cut would add upside pressure to money market yields with investors demanding a higher return for investing in a lower rated country's currency. However with the cut in the rating broadly expected there has been little impact on money market yields. In fact PWLB borrowing rates had reduced from the date of the announcement to 8th March 2013 with 10 year maturity rates falling from 3.21% to 3.09% and 50 year maturity rates falling from 4.51% to 4.45%. This reflects further political uncertainties in Europe following the recent Italian election but also highlights that the UK is still seen as a safe haven for foreign investment.

Critically, Moody's themselves stated that it did not consider that the one notch downgrade would have an effect on the UK entities and financial institutions that it individually rates, so we do not expect to see UK financial institutions subject to individual downgrades as a result of the sovereign credit rating downgrade.

5.2 It is felt that there has been little increase in the risk of investing with UK institutions following the downgrade by Moody's and a delegated decision was made on 12th March 2013 to amend the Lending List Criteria. The delegated decision increases the maximum deposit that can be placed with AAA rated counterparties from £90m to £110m and with AA+ counterparties from £50m to £90m and it applies the UK Government sovereign credit rating of AA+ when determining the limit on investments that can be placed with counterparties that have been nationalised or part nationalised and to group limits where counterparty institutions are part of a group of companies. The fact the AA+ criteria limit has been increased to £90m reflects the continued strength of the UK as a safe haven for foreign investment (which has not been affected by the downgrading) and also the fact that the financial markets had already factored in this possibility and remain unconcerned.

The effect of these changes to the Lending List Criteria will be to allow the Council to maintain its pre downgrade investment limits of £90 million with both Lloyds TSB and Royal Bank of Scotland banking groups. It is felt that as the UK Government holds a significant financial stake in these institutions that they would be very unlikely to be allowed to fail should the financial situation substantially deteriorate. On this basis the delegated decision is set out at Appendix A and is reflected in amendments to the Counterparty Criteria and Approved Lending List.

5.3 The Council's investment policy and lending criteria is regularly monitored and reviewed to ensure it takes changes in market or regulatory conditions into account. Any changes will be reported to future committee meetings as necessary.

6 Recommendation

6.1 Members are requested to note the change in the UK Sovereign Credit Rating and to endorse the record of decision made under delegated powers and associated amendments to the Lending List Criteria and Approved Lending List set out in Appendix A.