Sunderland City Council

Item No. 5

AUDIT AND GOVERNANCE COMMITTEE **29 June 2010**

TREASURY MANAGEMENT – REVIEW OF PERFORMANCE 2009/2010

Report of the Director of Financial Resources

1 Purpose of the Report

1.1 To report on the borrowing and investment performance for 2009/2010.

2 Description of Decision

2.1 The committee is requested to note the Treasury Management performance for 2009/2010.

3 Introduction

3.1 This report sets out the annual borrowing and investment performance for the financial year 2009/2010, in accordance with the requirements of the Treasury Management Policy and Strategy agreed by Council.

4 Review of Performance 2009/2010

Borrowing Strategy and Performance – 2009/2010

4.1 Cabinet agreed the Borrowing Strategy on 11th February 2009 and this was approved by Council on 4th March 2009. The basis of the strategy was to:

- continuously monitor prevailing interest rates and forecasts;
- secure long-term funds when market conditions were favourable;
- use a benchmark financing rate of 4.00% for long term borrowing (i.e. all borrowing for a period of one year or more);
- take advantage of debt rescheduling opportunities, as appropriate.

4.2 The Borrowing Strategy was reviewed by this committee in November 2009 and February 2010 and was reaffirmed on both occasions. The Borrowing Strategy for 2009/2010 was based upon interest rate forecasts from a wide cross section of City institutions, advice from the Council's Treasury Management advisers and from other available information sources e.g. The Financial Times, Treasury and Government forecasts etc.

4.3 This report also incorporates the requirements of the revised Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which was issued in December 2009 and was formally adopted by the Council on 3rd March 2010. The Council adopted most of the changes recommended in the revised Code earlier in the financial year, in response to a CIPFA consultation paper on Treasury Management and recommendations set out in the

"Risk and Return" report issued by the Audit Commission, which was brought about by the Icelandic banking crisis. The actions proposed and adopted were reported to this Committee and to Cabinet in June 2009.

4.4 The view in February 2009, at the time the Treasury Management Policy and Strategy was formed, was that variable rate borrowing was expected to become cheaper as the Base Rate was forecast to fall to 0.50% by the end of March 2009.
Thereafter variable rate borrowing was expected to remain at this level until Qtr 1 of 2010 before slowly rising to 4.0% over the following two years. The forecast for the long-term PWLB rates was for rates to fall in Q2 2009 (i.e. 25 year loans – 3.95% and 50 year loans between 3.85% and 3.90%) and would remain around those levels until Q1 2010 before slowly increasing to 5.05% for 25 year loans and to 5.00% for 50 year loans by the end of 2011/2012.

As expected, the Base Rate did fall to 0.50% in March 2009, where it has remained to the present day. However, as can be seen from the table below (showing the average borrowing rates for each quarter in 2009/2010) the longer term rates have been higher than the levels forecast:

Borrowing Period	Projected Rates	Actual Rates 2009 / 2010			
	%	Q1 %	Q2 %	Q3 %	Q4 %
7 day notice	0.5	0.46	0.38	0.31	0.30
1 year	-	0.97	0.93	0.83	0.87
5 year	2.18	2.80	2.97	2.83	2.99
10 year	2.60	3.72	3.88	3.91	4.22
25 year	3.95	4.57	4.43	4.35	4.64
50 year	3.85 to 3.90	4.66	4.45	4.36	4.62

During 2009/2010 the Bank of England's Monetary Policy Committee (MPC) was focused on helping the economy to recover from the deepest and longest recession the UK economy had experienced for many years. Despite keeping the Base Rate at an unprecedented historically low of 0.5% all year, the MPC also decided to increase the amount of liquidity (i.e. the quantity of money) in the economy by £200 billion. This process, known as 'quantitative easing', injects money into the economy, primarily by buying UK government bonds (known as gilts). As well as increasing liquidity, this also has the effect of boosting prices for gilts and corporate bonds, thereby bringing down yields, with the effect of reducing borrowing costs for both the business and the public sectors, particularly in the short to medium term borrowing periods.

4.5 The Council's borrowing requirement for 2009/2010 was assessed at around £35.0 million (as a result of 11.75% redeemable stock maturing in November 2008 and £30.0 million PWLB loans being prematurely repaid in January 2009). This borrowing was deferred from 2008/2009 as interest rates were forecast to fall. The aim was then to replace these loans in the short to medium term when either:

- the long term PWLB rate fell below 4.0%, or if this was unlikely to happen;,
- spreading the debt maturity pattern over a shorter period to take advantage of lower interest rates in these shorter periods and also to provide more flexibility for debt rescheduling opportunities in the future.

To date, £33.0 million of these loans have been replaced with new loans from the PWLB as detailed in the table below. All loans were below the 4.00% target rate set for long term borrowing and represent a lower cost of borrowing to the Council going forward.

Date	Lender	Amount £m	Period (Years)	Rate %	Benchmark % Rate	Margin %
18/06/09	PWLB	5.0	3.0	2.32	4.00	(1.68)
18/06/09	PWLB	5.0	4.0	2.73	4.00	(1.27)
22/06/09	PWLB	5.0	9.0	3.67	4.00	(0.33)
30/06/09	PWLB	5.0	10.0	3.71	4.00	(0.29)
30/06/09	PWLB	4.0	8.5	3.65	4.00	(0.35)
30/06/09	PWLB	4.0	11.5	3.99	4.00	(0.01)
13/10/09	PWLB	5.0	18.5	3.99	4.00	(0.01)
Total		**33.0**		**3.41**		

4.6 The Treasury Management Strategy for 2009/2010 included provision for debt rescheduling as follows: "….to secure further early debt redemption when (and if) appropriate opportunities arise. Consequently market conditions will be closely monitored to identify and take advantage of any such opportunities."

The Strategy also stated that because of the proactive approach taken by the Council in recent years, and because of the very low underlying rate of the Council's long term debt, it would be difficult to refinance long term loans at interest rates lower than those already in place.

In January 2010 however, advantage was taken of market conditions, which enabled a debt rescheduling exercise to be undertaken. As a result, £24.0 million of PWLB loans with an average rate of 4.20% (rates ranged from 4.15% to 4.30%) were prematurely repaid. The details of which are shown in the table below.

Date	Lender	Amount £m	Rate %	Premium / (Discount) £
12/01/10	PWLB	4.0	4.15	(46,699)
12/01/10	PWLB	4.0	4.15	(47,065)
12/01/10	PWLB	3.0	4.20	(5,908)
12/01/10	PWLB	3.0	4.20	0
12/01/10	PWLB	3.0	4.20	0
12/01/10	PWLB	3.0	4.30	60,144
12/01/10	PWLB	4.0	4.25	39,816
		24.0	**4.20**	**288**

It was considered prudent to repay these PWLB loans and use investments to temporarily finance the transaction. The consequent reduction in investments had a further benefit of reducing the counterparty risk as the Council had fewer funds to place by repaying this debt early. The cost of this rescheduling (£288) was almost cost neutral. However, the action taken will result in an annual net saving of interest of £817,000, until such time as the debt is replaced. As reported to the last meeting of this Committee, the debt has been part replaced as follows:

Date	Lender	Amount £m	Period Years	Rate %
21/05/10	PWLB	10.0	4	1.99*
21/05/10	PWLB	5.0	50	4.29*
		15.0		**2.76**

* Benchmark borrowing rate 2010/2011 is 4.50%

4.7 The Council has nine market Lender's Option / Borrower's Option (LOBO) loans totalling £39.5 million, of which £34.5 million are now flat rate vanilla LOBO's which have three year roll-over periods. This essentially means that these loans have become flat rate loans which are reviewed every 3 years. The other loan of £5.0 million still has a six monthly roll-over period. Details are shown in the table below.

Start Date	**Lender**	**Amount £m**	**Period Years**	**Rate %**	**Initial Fixed Period**	**Roll Over Period**	**Next Roll Over Date**
27/01/06	Dexia	5.0	60	4.32	27/01/09	3 Years	27/01/12
03/02/06	Dexia	5.0	60	4.37	03/02/10	3 Years	03/02/13
22/02/06	Dexia	5.0	60	4.38	22/02/10	3 Years	22/02/13
12/06/06	Barclays	9.5	60	4.37	12/12/08	3 Years	10/12/11
14/08/06	Barclays	5.0	60	4.45	14/08/07	3 Years	14/08/10
30/09/06	Dexia	5.0	60	4.32	29/09/09	3 Years	29/09/12
21/10/03	Barclays	5.0	40	4.50	23/04/07	6 Mths **	23/10/10
Total		**39.5**					

Lender Option Borrower Option – Vanilla arrangements

**This LOBO converted from its original front-end rate of 2.55% to 4.50% on 23rd April 2007, under the terms of the loan.

The Treasury Management team will continue to monitor this loan for an opportunity to renegotiate the loan on more favourable terms, but this is unlikely to happen in the current interest rate environment.

4.8 The Council's borrowing portfolio position at 31st March 2010 was:

		Principal (£m)	**Total (£m)**	**Average Rate (%)**
Borrowing				
Fixed Rate Funding	PWLB	107.5		
	Market	29.5		
	Other	0.4	137.4	3.96
Variable Rate Funding	PWLB	0.0		
	Market	10.0		
	Temporary/ Other	30.9	40.9	1.37
Total Borrowing			**178.3**	**3.37**
Total Investments	In House		**172.0**	**1.91**
Net Debt			**6.3**	

Prudential Indicators – 2009/2010

4.9 All external borrowing and investments undertaken in 2009/2010 have been subject to the monitoring requirements of the Prudential Code. Under the code, Authorities must set borrowing limits (Authorised Borrowing Limit for External Debt and Operational Boundary for External Debt) and must also report on the Council's performance for all of the other Prudential Indicators, please see 4.10 below for more details.

The statutory limit under section 3(1) of the Local Government Act 2003 (known as the Authorised Borrowing Limit for External Debt) was originally set by the Council for 2009/2010 in total as £333.322m which was detailed as follows:

	£m
Borrowing	331.759
Other Long Term Liabilities	1.563
Total	**333.322**

The above limit was reviewed but it was considered that the total limit could accommodate the increase arising from the inclusion of PFI schemes and finance leases being brought on to the Balance Sheet which only affected the amount to be shown as Other Long Term Liabilities. The structure of the Authorised Limit thus was revised to show that:

	£m
Borrowing	241.769
Other Long Term Liabilities	91.563
Total	**333.332**

The Operational Boundary for External Debt for 2009/2010 was initially set at £227.212m. This was increased by Council on 3rd March 2010 to include an element for long-term liabilities relating to PFI schemes and finance leases, which are to be brought on Balance Sheet in accordance with the SORP 2009 and thus needed to be amended and included in the calculation of the operational boundary for 2009/2010.

The revised operational boundary is set out below:

	£m
Borrowing	200.918
Other Long Term Liabilities	91.563
Total	**292.481**

The Council's maximum external debt in 2009/2010 was £259.569 million (which includes borrowing in respect of other organisations such as Tyne and Wear Fire and Rescue Authority), and is well within both of the above limits.

4.10 The table below shows that all other Treasury Management Prudential Indicators have been complied with during 2009/2010, and these are set out in the table overleaf

Prudential Indicators		2009/2010	
		Limit £'000	**Actual £'000**
P10	**Upper limit for fixed interest rate exposure**		
	Net principal re fixed rate borrowing / investments	70,000	27,367
P11	**Upper limit for variable rate exposure**		
	Net principal re variable rate borrowing / investments	30,000	26,867
P12	**Maturity Pattern**	Upper Limit	
	Under 12 months	40%	18.18%
	12 months and within 24 months	50%	0.01%
	24 months and within 5 years	50%	5.66%
	5 years and within 10 years	75%	7.90%
	10 years plus	100%	81.71%
	A lower limit of 0% for all periods		
P13	**Upper limit for total principal sums invested for over 364 days**	100,000	35,000

4.10 The impact on the borrowing costs of the Council in following its Borrowing Strategy has produced the following effect on the Council's "pool rate" of interest over the last five years as follows

2005/06	4.31%
2006/07	4.58%
2007/08	4.71%
2008/09	4.14%
2009/10	2.89%

The movement in the pool rate reflects long term fixed rate borrowing decisions and the movement in market rates. The Base Rate reduction to 0.5% together with the debt rescheduling carried out by the council and cheaper replacement PWLB loans acquired (see 4.5 above) has resulted in a decrease of 1.25% in the pool rate from 4.14% in 2008/2009 to 2.89% for 2009/2010.

5. Investment Strategy and Performance – 2009/2010

5.1 The Annual Investment Strategy basically sets out the type of investments the Council can use for the purpose of investments and makes specific reference to:

- the procedures for determining the use of each asset class, (advantages and associated risk), particularly if the investment falls under the category of "non-specified investments";

- the maximum periods for which funds may be prudently committed in each asset class;
- the amount or percentage limit to be invested in each asset class;
- whether the investment instrument is to be used by the Council's in-house officers and/or by the Council's appointed external fund managers (if used); and, if non-specified investments are to be used in-house, whether prior professional advice is to be sought from the Council's treasury advisers;
- the minimum amount to be held in short-term investments (i.e. one which the Council may require to be repaid or redeemed within 12 months of making the Investment).

5.2 The Annual Investment Strategy has been fully complied with in 2009/2010 with the exception that for a short period of time there were a limited number of departures in respect of section 13.4 of the Annual Investment Strategy which states that "the minimum amount of overall investments that the Council will hold in short-term investments (less than one year) is £50m. As the Council has decided to restrict most of its investments to term deposits, it will maintain liquidity by having a minimum of 50% of these short-term investments maturing within 6 months".

This occurred because of the need to mitigate the risk of the fall in interest rates on investments, which meant more funds were temporarily placed for longer than 6 months in accordance with the approved Lending List and Criteria in order to maximise investment income with what are regarded as very safe and secure institutions which also have the government guarantee in place. This position had no impact upon the Prudential Indicators as reported and was actually beneficial to the council in higher returns on investments than would have been the case otherwise. Also the Annual Investment Strategy was amended to recognise the fact that the 50% limit in 2009/2010 was being unnecessarily restrictive and this was revised to 40% for 2010/2011.

5.3 At 31st March 2010 the Council had outstanding investments of £172.0 million. The table below shows the return made on the Council's total investments for 2009/2010 as compared with the 7 Day rate, which the Council has used historically to assess its performance.

	2009/2010 Return %	**2009/2010 Benchmark %**
In-house Managed Funds	**1.91**	**0.36**

This return far exceeded the benchmark set for 2009/2010 and represents a very good achievement in a year that has seen a great deal of uncertainty and volatility in the financial markets.

5.4 All investments placed in 2009/2010 have been made in accordance with the approved Criteria and the Approved Lending List which was agreed in the 11th February 2009 Cabinet Report and approved by Council on 4th March 2009.

5.5 In view of the present economic climate and the current situation with the financial markets the Director of Financial Resources, in consultation with the Cabinet Portfolio holder for Resources, has the delegated authority to vary the Lending List Criteria and Lending List itself should circumstances dictate, on the basis that changes be reported to Cabinet and the Audit and Governance Committee retrospectively, in accordance with normal Treasury Management reporting procedures.

5.6 As members will be aware, the regular updating of the Council's Authorised Lending List and Criteria is required in the light of financial institution mergers and changes in institutions' credit ratings. These changes have already been reported to members in detail previously but for information the position as at 31st March 2010 is shown in the attached Appendices, which reflect the limited changes made during the year.

6. **Reasons for Decisions**

6.1 To note the performance for 2009/2010.

7. **Alternative Options**

7.1 No alternatives are submitted for Cabinet consideration.

Background Papers

Sector CityWatch (Monthly) and weekly credit rating list
Sector / Capital Economics / UBS Economic forecasts
Local Government Act 2003
Treasury Management in the Public Services Code of Practice
The Prudential Code for Capital Finance
Audit Commission Risk and Return Report (March 2009)
CIPFA Treasury Management Code of Practice consultation on proposed changes
Revised CIPFA Treasury Management Code of Practice (December 2009)
The Financial Times

LENDING LIST CRITERIA

Counterparty Criteria

The Council takes into account not only the individual institution's credit ratings issued by all three credit rating agencies (Fitch, Moody's and Standard & Poor's), but also all available market data and intelligence, the level of government support and advice from its Treasury Management advisors.

Set out below are the criteria to be used in determining the level of funds that can be invested with each institution. Where an institution is rated differently by the rating agencies, the lowest rating will determine the level of investment.

Fitch / S&P's Long Term Rating	Fitch Short Term Rating	S&P's Short Term Rating	Moody's Long Term Rating	Moody's Short Term Rating	Maximum Deposit £m	Maximum Duration
AAA	F1+	A1+	Aaa	P-1	40	2 Years
AA+	F1+	A1+	Aa1	P-1	40	2 Years
AA	F1+	A1+	Aa2	P-1	30	364 days
AA-	F1+ / F1	A1+ / A-1	Aa3	P-1	20	364 days
A+	F1	A-1	A1	P-1	10	364 days
A	F1 / F2	A-1 / A-2	A2	P-1 / P-2	10	364 days
A-	F1 / F2	A-2	A3	P-1 / P-2	5	6 months
Local Authorities (limit for each local authority)					30	364 Days

Where the UK Government holds a shareholding in an institution the UK Government's credit rating of AAA will be applied to that institution to determine the amount the Council can place with that institution.

The Code of Practice for Treasury Management in the Public Services recommends that consideration should also be given to country, sector, and group limits in addition to the individual limits set out above, these new limits are as follows:

Country Limit

At present, only UK institutions are included on the Council's approved Lending List. It is proposed that only countries with a minimum sovereign credit rating of AA+ by all three rating agencies will be considered for inclusion on the Approved Lending List.

It is also proposed to set a limit of £30 million for all countries except for the UK provided they meet the above criteria. A separate limit of £250 million will be applied to the United Kingdom and is based on the fact that the government has done and is willing to take action to protect the UK banking system.

Country	Limit £m
UK	250
Non UK	30

Sector Limit

The Code recommends a limit be set for each sector in which the Council can place investments. These limits are set out below:

Sector	Limit £m
Central Government	250
Local Government	250
UK Banks	250
UK Building Societies	150
Foreign Banks	0

Group Limit

Where institutions are part of a group of companies e.g. Lloyds Banking Group, Santander and RBS, then total limit of investments that can be placed with that group of companies will be determined by the highest credit rating of a counterparty within that group, unless the government rating has been applied.

This will apply provided that:

- the government's guarantee scheme is still in place;
- the UK continues to have a sovereign credit rating of AAA; and
- that market intelligence and professional advice is taken into account.

Current group limits are set out in Appendix 2.

Approved Lending List **Appendix 2**

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength Rating	L Term	S Term	Limit £m	Max Deposit Period
UK	AAA	F1+			Aaa			AAA		250	364 days
Lloyds Banking Group (see Note 1)										**Group Limit 40**	
Lloyds Banking Group plc	AA-	F1+	C	1	A1	-	-	A	A-1	40	364 days
Lloyds TSB Bank Plc	AA-	F1+	C	1	Aa3	P-1	C-	A+	A-1	40	364 days
Bank of Scotland Plc	AA-	F1+	C	1	Aa3	P-1	D+	A+	A-1	40	364 days
Royal Bank of Scotland Group (See Note 1)										**Group Limit 40**	
Royal Bank of Scotland Group plc	AA-	F1+	D/E	1	A1	-	-	A	A-1	40	364 days
The Royal Bank of Scotland Plc	AA-	F1+	D/E	1	Aa3	P-1	C-	A+	A-1	40	364 days
National Westminster Bank Plc	AA-	F1+	-	1	Aa3	P-1	C-	A+	A-1	40	364 days
Ulster Bank Ltd	A+	F1+	E	1	A2	P-1	D-	A	A-1	40	364 days
Santander Group *										**Group Limit 30**	
Santander UK plc	AA-	F1+	B	1	Aa3	P-1	C-	AA	A-1+	30	364 days
Abbey National Treasury Services plc	AA-	F1+	-	-	Aa3	P-1	-	-	-	30	364 days
Alliance and Leicester plc	AA-	F1+	B	1	Aa3	P-1	E+	AA	A-1+	30	364 days
Barclays Bank plc *	AA-	F1+	B	1	Aa3	P-1	C	AA-	A-1+	30	364 days
HSBC Bank plc *	AA	F1+	B	1	Aa2	P-1	C+	AA	A-1+	30	364 days
Nationwide BS *	AA-	F1+	B	1	Aa3	P-1	C-	A+	A-1	30	364 days
Standard Chartered Bank *	A+	F1	B	1	A2	P-1	C+	A+	A-1	30	364 days
Clydesdale Bank / Yorkshire Bank **	AA-	F1+	C	1	A1	P-1	C-	A+	A-1	10	364 days
Co-Operative Bank Plc	A-	F2	B/C	3	A2	P-1	D+	-	-	5	6 months
Northern Rock	A+	-	-	-	-	-	-	A	A-1	10	364 days

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength Rating	L Term	S Term	Limit £m	Max Deposit Period
Top 10 Building Societies (by asset size)											
Nationwide BS (see above)											
Yorkshire BS	A-	F2	B/C	3	Baa1	P-2	D+	A-	A-2	0	
Coventry BS	A	F1	B	3	A3	P-2	C-	-	-	5	6 Months
Chelsea BS ***	BBB+	F2	C	3	Baa3	P-3	E+	-	-	0	
Skipton BS	A-	F2	B/C	3	Baa1	P-2	D+	-	-	0	
Leeds BS	A	F1	B/C	3	A2	P-1	C+	-	-	10	364 Days
West Bromwich BS ***	BBB-	F3	C/D	3	Baa3	P-3	E+	-	-	0	
Principality BS ***	BBB+	F2	C	3	Baa2	P-2	D-	-	-	0	
Newcastle BS ***	BBB-	F3	C/D	3	Baa2	P-2	D-	-	-	0	
Norwich and Peterborough BS ***	BBB+	F2	C	3	Baa2	P-2	D	-	-	0	

Notes

Note 1 **Nationalised / Part Nationalised**
The counterparties in this section will have the UK Government's AAA rating applied to them thus giving them a credit limit of £40 million for a maximum period of 364 days

* Banks / Building Societies which are part of the UK Government's Credit Guarantee scheme
The counterparties in this section will have a AA rating applied to them thus giving them a credit limit of £30 million for a maximum period of 364 days

** The Clydesdale Bank (under the UK section) is owned by National Australia Bank

*** These will be revisited and used only if they meet the minimum criteria (ratings of A- and above)

Any bank which is incorporated in the United Kingdom and controlled by the FSA is classed as a UK bank for the purposes of the Approved Lending List