Sunderland City Council

Item No. 5

AUDIT AND GOVERNANCE COMMITTEE **10 February 2012**

TREASURY MANAGEMENT – THIRD QUARTERLY REVIEW 2011/2012

Report of the Executive Director of Commercial and Corporate Services

1. Purpose of Report

1.1 To report on the Treasury Management, (TM) performance for the third quarter of 2011/2012.

2. Description of Decision

2.1 The Committee is requested to note the Treasury Management performance for Quarter 3 of 2011/2012;

2.2 To approve the amendments (detailed in bold print) to both the Lending List Criteria set out in Appendix B and the Lending List set out in Appendix C.

3. Introduction

3.1 The report sets out the Treasury Management performance to date for the third quarter of the financial year 2011/2012, in accordance with the requirements of the Treasury Management Policy and Strategy agreed by Council.

4. Review of the Treasury Management Performance for 2011/2012 – Quarter 3

4.1 The performance of the Council's treasury management function continues to contribute financial savings to support future year's capital programmes and helps to support the Council's revenue budget by reducing borrowing costs by taking advantage of debt rescheduling opportunities as appropriate. At this stage, no debt rescheduling has been undertaken in 2011/2012 as rates have not been considered sufficiently favourable, but it should also be recognised that the Council's interest rate on borrowing is very low, currently averaging 3.42%, and as such the council continues to benefit from this low cost of borrowing and from the ongoing savings from past debt rescheduling exercises;

4.2 Treasury Management Prudential Indicators are regularly reviewed and the Council is within the limits set for all of its TM Prudential Indicators;

4.3 The investment policy is also regularly monitored and reviewed to ensure it has flexibility to take full advantage of any changes in market conditions to the benefit of the Council.

4.4 As at 31st December 2011, the funds managed by the Council's Treasury Management team has achieved a rate of return on its investments of 1.63% compared with the benchmark rate (i.e. the 7 day rate) of 0.50%. Performance is very positive and is significantly above the benchmark rate, whilst still adhering to the prudent policy agreed by the Council.

4.5 As a result the increased rate of return achieved on investments held by the Authority to date has generated additional interest above the budget target for 2011/12 of almost £1.1 million (up to the end of December 2011).

4.6 More detailed Treasury Management information is included in Appendix A for members' information.

<u>Background Papers</u>

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 and Cross-Sectoral Guidance Notes (2011 Edition)

Appendix A

Detailed Treasury Management Performance Quarter 3 - 2011/2012

A1. Borrowing Strategy and Performance - 2011/2012

A1.1 The borrowing strategy for 2011/2012 was reported to Cabinet on 11th February 2011 and approved by full Council on 2nd March 2011.

The Borrowing Strategy was based upon interest rate forecasts from a wide cross section of City institutions. The view in February 2011, at the time the Treasury Management Policy and Strategy was drafted, was the Bank Base Rate was expected to increase over the next three financial years from its current level of 0.50% to 0.75% by December 2011, and to 3.25% by March 2014. It was anticipated that PWLB borrowing rates would steadily increase throughout 2011/2012 across all periods with the 5 years PWLB forecast to be around 3.5% by March 2012, and the 25 year and 50 year PWLB rates to be at the 5.3% mark.

Economists are now forecasting that the first increase in the bank base rate will be in September 2013. PWLB rates and bond yields remain extremely unpredictable and there are exceptional levels of volatility which are highly correlated to political developments in the Eurozone and the sovereign debt crisis within a number of Eurozone countries with the risk of further contagion.

Interest rate forecasts have altered as a result of two major events: -

1. The decision by the MPC to expand quantitative easing by a further £75bn. This tranche is due to be completed in February 2012. This decision had an immediate effect of depressing (lowering) gilt yields at the long end of the curve. It also clearly underlined how concerned the MPC is about the prospects for UK growth and that recession is now a much greater concern than inflation.

2. The marked deterioration of growth prospects in the major world economies especially as concerns have further increased over Greece and the potential fall out from their debt position exacerbating problems within other countries economies. This has led in turn to a further increase in safe haven flows into UK gilts which have depressed gilt yields and pushed PWLB rates to even lower levels.

These developments have left short term forecasts for PWLB rates greatly out of line with actual rates and have substantially pushed back expectations of the timing of the eventual start of increases in Bank Rate gilt yields and PWLB rates.

The following table overleaf shows the average borrowing rates for Q1, Q2 and Q3 in 2011/2012.

2011/2012	Qtr 1 (Apr - June) %	Qtr 2 (July – Sept) %	Qtr 3 (Oct – Dec) %
7 days notice	0.40	0.38	0.37
1 year	1.69	1.50	1.39
5 year	3.29	2.59	2.25
10 year	4.51	3.82	3.33
25 year	5.22	4.84	4.22
50 year	5.16	4.88	4.28

A1.2 The strategy for 2011/2012 was to adopt a pragmatic approach and to respond to any changing circumstances to seek to secure benefit for the Council. A benchmark financing rate of 5.50% for long-term borrowing was set for 2011/2012. Due to high levels of volatility in the financial markets, with borrowing rates still forecast to remain low over the short term, no new borrowing had been undertaken in the current financial year up to 31st December 2011.

A1.3 The Borrowing Strategy for 2011/2012 made provision for debt rescheduling but 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.

At this stage, no debt rescheduling has been undertaken during 2011/2012 as rates have not been considered sufficiently favourable for rescheduling.

The strategy for the remainder of 2011/2012 is for the Treasury Management team to continue to monitor market conditions and secure early debt redemption if appropriate opportunities arise. Any rescheduling undertaken will be reported to Cabinet in line with the current Treasury Management reporting procedures.

The Council's treasury portfolio position at 31st December 2011 is set out below:

		Principal (£m)	Total (£m)	Average Rate (%)
Borrowing				
Fixed Rate Funding	PWLB	138.0		
	Market	24.5		
	Other	0.3	162.8	3.83
Variable Rate Funding	PWLB	0.0		
	Market	15.0		
	Temporary/ Other	30.0	45.0	1.98
Total Borrowing			**207.8**	**3.42**

A2. Treasury Management Prudential Indicators – 2011/2012

A2.1 All external borrowing and investments undertaken in 2011/2012 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 report on the Council's performance for all of the other TM Prudential Indicators.

A2.2 The statutory limit under section 3(1) of the Local Government Act 2003 (which is also known as the Authorised Borrowing Limit for External Debt) was set by the Council for 2011/2012 as follows:

	£m
Borrowing	331.539
Other Long Term Liabilities	50.860
Total	**382.399**

The Operational Boundary for External Debt was set as shown below: -

	£m
Borrowing	261.603
Other Long Term Liabilities	50.860
Total	**312.463**

The maximum external debt in respect of borrowing in 2011/2012 (to 31st December 2011) was £208.943 million (which includes borrowing in respect of other organisations such as Tyne and Wear Fire and Rescue Authority but excludes other long term liabilities such as PFI and Finance leases which already include borrowing instruments) and is well within the borrowing limits set by both of these indicators.

A2.3 The table below shows that all other Treasury Management prudential indicators have been complied with.

Prudential Indicators	**2011/2012 (to 31/12/2011) Limit £'000**	**Actual £'000**
P10 Upper limit for fixed interest rate exposure Net principal re fixed rate borrowing / investments	105,000	29,986
P11 Upper limit for variable rate exposure Net principal re variable rate borrowing / investments	60,000	22,395
P13 Upper limit for total principal sums invested for over 364 days	100,000	0

A2.4 The Council is currently within the limits set for all of its TM Prudential Indicators.

A3. Investment Strategy – 2011/2012

A3.1 The Investment Strategy for 2011/2012 was approved by Council on 2nd March 2011. The general policy objective for the Council is the prudent investment of its treasury balances. The Council's investment priorities in order of importance are:

(A) The **security** of capital;
(B) The **liquidity** of its investments and then
(C) The Council aims to achieve the **optimum yield** on its investments but this is commensurate with the proper levels of security and liquidity.

A3.2 As at 31st December 2011 the funds managed by the Council's in-house team amounted to £194.985 million and all investments complied with the Annual Investment Strategy. The table below shows the return received on these investments as compared with the Council's benchmark rate (i.e. the 7 day rate).

	2011/2012 Actual to 31/12/2011 %	**2011/2012 Benchmark to 31/12/2011 %**
Return on investments (to 31st December 2011)	1.63	0.50

A3.3 Investments placed in 2011/2012 have been made in accordance with the approved investment strategy and comply with the counterparty criteria used to identify organisations on the Approved Lending List in place.

A3.4 However the investment policy is regularly monitored and reviewed to ensure it has flexibility to take full advantage of any changes in market conditions to the benefit of the Council. There are no changes to report.

A3.5 Investment rates available in the market have continued at historically low levels.

A3.6 Due to the continuing high volatility within the financial markets, particularly in the euro zone, advice from our Treasury Management advisers (which we agree with) is to continue to restrict investments to all financial institutions for shorter term periods.

A3.7 Advice also continues that the above guidance is not applicable to institutions considered to be very low risk because the government holds shares in these organisations (i.e. Lloyds TSB and RBS) or in respect of Money Market Funds which are also AAA rated.

A3.8 The regular updating of the Council's authorised lending list is required to take into account financial institution mergers and changes in institutions' credit ratings. The Counterparty Criteria is shown in Appendix B and the Approved Lending List is shown in Appendix C have been updated with the proposed changes outlined above and summarised in 4.3 of the report.

Appendix B

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	70	2 Years
AA+	F1+	A1+	Aa1	P-1	50	2 Years
AA	F1+	A1+	Aa2	P-1	40	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	**2 Years**
UK Government (including debt management office, gilts and treasury bills)					**70**	**5 years**
Money Market Funds Maximum amount to be invested in Money Market Funds is £50 million with a maximum of £30 million in any one fund.					50	**Liquid Deposits**

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 for a maximum period of **2 years**.

Where any banks / building societies are part of the UK Government's Credit Guarantee scheme (marked with * in the Approved Lending List), these counterparties will have an AA rating applied to them thus giving them a credit limit of £40 million for a maximum period of 364 days.

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
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 total limit of £40 million which can be invested in other countries provided they meet the above criteria. A separate limit of £300 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	300
Non UK	40

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	300
Local Government	300
UK Banks	300
UK Building Societies	150
Money Market Funds	**50**
Foreign Banks	40

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 C

Approved Lending List

Appendix C

	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		300	2 years
Lloyds Banking Group (see Note 1)										Group Limit 70	
Lloyds Banking Group plc	**A**	**F1**	**bbb**	1	**A2**	-	-	**A-**	**A-2**	70	**2 years**
Lloyds TSB Bank Plc	**A**	**F1**	**bbb**	1	**A1**	P-1	C-	**A**	A-1	70	**2 years**
Bank of Scotland Plc	**A**	**F1**	**-**	1	**A1**	P-1	D+	**A**	A-1	70	**2 years**
Royal Bank of Scotland Group (See Note 1)										Group Limit 70	
Royal Bank of Scotland Group plc	**A**	**F1**	**bbb**	1	**A1**	**P-2**	**-**	**A-**	**A-2**	70	**2 years**
The Royal Bank of Scotland Plc	**A**	**F1**	**bbb**	1	**A3**	P-1	C-	**A**	A-1	70	**2 years**
National Westminster Bank Plc	**A**	**F1**	**-**	1	**A2**	P-1	C-	**A**	A-1	70	**2 years**
Ulster Bank Ltd	**A-**	**F1**	**ccc**	1	**Baa1**	**P-2**	D-	**BBB+**	**A-2**	70	**2 years**
Santander Group *										Group Limit 40	
Santander UK plc	**A+**	**F1**	**a+**	**1**	**A1**	P-1	C-	**AA-**	A-1+	40	364 days
Cater Allen	**-**	**-**	-	**-**	-	**-**	-	**-**	-	40	364 days
Barclays Bank plc *	**A**	**F1**	**a**	1	Aa3	P-1	C	**A+**	**A-1**	40	364 days
HSBC Bank plc *	AA	F1+	**aa-**	1	Aa2	P-1	C+	**AA**	A-1+	40	364 days

Appendix C (continued)

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength	L Term	S Term	Limit £m	Max Deposit Period
Nationwide BS *	**A+**	**F1**	**a+**	1	**A2**	P-1	C	A+	A-1	40	364 days
Standard Chartered Bank *	AA-	F1+	**aa-**	1	**A1**	P-1	B-	**AA-**	**A-1+**	40	364 days
Clydesdale Bank / Yorkshire Bank **	**A+**	**F1**	**bbb**	1	**A2**	P-1	C-	**BBB**	**A-2**	**0**	364 days
Co-Operative Bank Plc	A-	F2	**a-**	3	**A3**	**P-2**	**C-**	-	-	5	6 months
Northern Rock ***	BBB+	F2	**bbb +**	2	-	-	-	**BBB+**	A-2	0	
Top Building Societies (by asset value)											
Nationwide BS (see above)											
Yorkshire BS ***	**BBB+**	F2	**bbb +**	5	**Baa2**	P-2	C-	A-	A-2	0	
Coventry BS	**A**	F1	**a**	5	A3	P-2	C	-	-	5	6 months
Skipton BS ***	**BBB**	**F3**	**bbb**	5	**Ba1**	**NP**	D+	-	-	0	
Leeds BS	**A-**	**F2**	**a-**	5	**A3**	**P-2**	**C**	-	-	**5**	**6 months**
West Bromwich BS ***	**B+**	**B**	**b+**	5	**B2**	**NP**	E+	-	-	0	
Principality BS ***	BBB+	F2	**bbb +**	5	**Ba1**	**NP**	D+	-	-	0	
Newcastle BS ***	**BB+**	**B**	**bb+**	5	**-**	**-**	**-**	-	-	0	
Nottingham BS	-	-	-	-	**Baa2**	P-2	C-	-	-	**0**	
Foreign Banks have a combined total limit of £40m											
Australia	**AAA**	-	-	-	Aaa	-	-	AAA		40	364 Days
National Australia Bank	AA	F1+	**aa**	1	**Aa2**	P-1	**B-**	**AA-**	A-1+	40	364 Days
Australia and New Zealand Banking Group Ltd	AA-	F1+	**aa-**	1	**Aa2**	P-1	**B-**	**AA-**	A-1+	20	364 Days
Commonwealth Bank of Australia	AA	F1+	**aa**	1	**Aa2**	P-1	**B-**	**AA-**	A-1+	40	364 Days
Westpac Banking Corporation	AA	F1+	**aa**	1	**Aa2**	P-1	**B-**	**AA-**	A-1+	40	364 Days

Appendix C (continued)											
	Fitch				**Moody's**			**Standard & Poor's**			
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength	L Term	S Term	Limit £m	Max Deposit Period
Canada	AAA				Aaa			AAA		40	364 Days
Bank of Nova Scotia	AA-	F1+	**aa-**	1	Aa1	P-1	B	AA-	A-1+	20	364 Days
Royal Bank of Canada	AA	F1+	**aa**	1	Aa1	P-1	**B**	AA-	A-1+	20	364 Days
Toronto Dominion Bank	AA-	F1+	**aa-**	1	Aaa	P-1	B+	AA-	A-1+	20	364 Days
Money Market Funds										50	**Liquid Deposits**
Prime Rate Stirling Liquidity	AAA MMF							AAAm		30	**Liquid Deposits**
Insight Liquidity Fund					AAA MR1			AAAm		30	**Liquid Deposits**
Ignis Sterling Liquidity	AAA MMF							AAAm		30	**Liquid Deposits**

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 £70 million for a maximum period of **2 years**

* 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 £40 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