Sunderland City Council

Item No. 6

AUDIT AND GOVERNANCE COMMITTEE **28 May 2010**

TREASURY MANAGEMENT IN LOCAL AUTHORITIES – REVIEW

Report of the Director of Financial Resources

1. Purpose of Report

1.1 To set out a review of the Council's Treasury Management arrangements approved by Council on 3rd March 2010, to ensure that there is adequate and sufficient flexibility built into the existing Treasury Management Strategy and Policy to meet current demands. This review allows the Council to take positive actions and proactively manage its borrowing and investment portfolios, in what is an uncertain future, in the financial markets now that the outcome of the General Election has been determined, which has resulted in a coalition government for the first time since 1974. An emergency budget has been announced by the new government for 22nd June 2010, which could have implications for the financial markets and it is important to ensure that the Council's Treasury Management Strategy and Policy remains fit for purpose and can accommodate and respond to changes in market conditions.

1.2 To set out the details of a Delegated Decision made on 18th May 2010, which was made in consultation with Councillor Dave Allan (Cabinet Portfolio Holder for Resources), the details of which are set out in Appendix 1 to this report, and is required to be reported retrospectively to this Committee and to Cabinet for information.

1.3 To note and inform the Committee that the Council has taken out new borrowing of £500,000 on 11th May 2010 at a rate 3.65% for a period of 15 years. This was an earmarked, Equal Instalment of Principal (EIP) loan, made on behalf of Beamish Museum Joint Committee to enable them to acquire Edwardian Fairground attractions (Steam Gallopers and a steam organ, Lighthouse Slip and Swing boats) for use in the Museum to help improve the visitor experience and generate income. The Joint Committee will fully repay the loan and interest (which is under their target rate of 3.82%) over the 15 year term of the loan in line with the agreed repayments.

2. Review of the Council's Treasury Management Strategy and Policy

2.1 Current Position

The new coalition government has indicated that it is to make £6 billion worth of savings in the economy in this current financial year but it is not yet clear how and where these savings will be made. Financial markets have initially responded positively to this news with a general fall in interest rates in PWLB loans, particularly at the shorter term period (up to 10 years). However, markets remain concerned about the impact of the deficits and the austerity measures being introduced into the economies of Greece, Spain, Portugal and Eire and the threat that a possible double dip recession could be encountered in the UK, if spending cuts are introduced too quickly. It is against this backdrop and uncertainty that the Treasury Management function must operate. The Council must ensure that it's Strategy and Policy is flexible and robust enough to be able it to cope with future market conditions and that it can, where appropriate, optimise opportunities that may arise.

To achieve this aim the Borrowing and Investment Strategies have been reviewed and the outcomes of the review are set out below.

2.2 Borrowing Strategy

It is concluded that:

a) the current strategy is considered robust and it is proposed that the target rate of 4.5% for new borrowing should remain for 2010/2011; market conditions will continue to be monitored and the rate kept under review in subsequent treasury management review reports;

b) there is no immediate need to replace the £26.6 million debt that was rescheduled mainly in January of this year, but it is proposed that interest rates and projections are carefully and closely monitored, to ensure the Council replaces the debt taking account of maturity profile and the target rate of 4.5%;

c) the policy of rescheduling debt to generate revenue savings and replacing the debt at a later date with cheaper short to medium term debt, when market conditions are favourable, will continue to be monitored to take advantage of any opportunities that arise; this policy will be kept under review as market conditions change.

In summary, the Director of Financial Resources in consultation with the Council's Treasury Management advisers, taking account of all other available market intelligence, will continue to adopt a pragmatic approach to debt management policy and will actively monitor and review this strategy. Any significant developments or changes in market conditions will be reported to this Committee and Cabinet as appropriate, together with the implications on the existing policy and strategy.

2.3 Investment Strategy

a) The Investment Strategy adopted and approved by the Council has the primary objective of protecting the Council's investments, then the liquidity needs of the Council are considered, before yield or rate of return is addressed. This policy has always been followed by the Council, which is in line with best practice and complies fully with the revised CIPFA Treasury Management Code of Practice 2009.

b) The current strategy specifies the type of investment that can be made, the period of such investments, the counterparty criteria and provides details of all institutions included on the Council's approved Lending List, which are regarded as being low risk, to minimise the risk of default associated with the investment of Council monies.

c) The Policy and Strategy is strictly followed by the Treasury Management team and measures are in place to monitor and report compliance and achievements of the team.

d) Cash flow management can be a difficult process to manage successfully and forecasting can be subject to wide variations as cash flows tend to fluctuate significantly throughout the year. Measures in place to manage the Council's investments therefore need to be regularly reviewed to ensure the above strategy can be maintained and adhered to. The Council has seen its net cash inflows increase significantly in recent months, which was projected by the new and improved cash flow processes that are in place, and as such there was a need to review the Council's Lending Criteria and Lending List Limits to accommodate this position. The Director of Financial Resources consequently, under delegated powers, on 18th May 2010 in consultation with Councillor D. Allan (Cabinet Portfolio Holder for Resources), made a Delegated Decision to amend the investment limits on both the Lending Criteria (Appendix 2) and Lending List (Appendix 3) to help alleviate potential problems with the placement of funds.

In summary, the Investment Strategy and Policy is considered robust. However, the options available to the Council for the placement of funds would benefit from further review to add other options that will assist with the investment of funds over the short to medium term. Only measures that are viewed as low risk have been considered. The options set out below will increase choice and flexibility to an already prudent Investment Strategy.

3. Further Options to recommend

3.1 Add UK Counterparties to the Lending List that conform to the Council's approved Lending Criteria. There are currently two such UK registered banks that can be included on the Council's Lending List and these are as follows:

Sumitomo Mitsui Banking Corporation Europe Ltd (Japan)
Ratings: Fitch: A, Moody's: Aa2; Standard and Poor's(S&P): A+

HFC Bank – subsidiary of HSBC
Ratings: Fitch: AA-, Moody's: A3, Standard and Poor's: not rated

Benefits

- Complies with the Treasury Management policy already approved by Council;
- The banks are incorporated in the UK and regulated by the Financial Services Authority (FSA) and are therefore classified as UK banks;

Risks

- If Sumitomo ever got into difficulty it would look to Japan (AA rated) for initial support, not the UK;
- These banks are not always in the market for funds.

The above option will not require any alteration to Council Policy, the Lending Criteria and approved limits have already been approved by the Council, but the institutions will need to be included on the Counterparty Lending List, if approved.

3.2 Add limited foreign counterparties

It is considered timely to review the position with regard to foreign banks, which was trailed and mentioned in previous reports for those institutions located in countries that weathered the banking crisis better than most. The two economies where this is especially the case is Australia and Canada.

It is proposed to consider the following banks for inclusion in the Council's Lending List and the foreign banks limit will need to be increased in the Lending Criteria to accommodate this option.

Australia - country rating AA+

Institutions

National Australia Bank (owns Yorkshire/Clydesdale who are already on the Lending List)
Ratings: Fitch: AA, Moody's: Aa1, S&P's: AA
Australia and New Zealand Banking Group Ltd
Ratings: Fitch: AA-, Moody's: Aa1, S&P's: AA
Commonwealth Bank of Australia
Ratings: Fitch: AA, Moody's: Aa1, S&P's: AA
Westpac Banking Corporation
Ratings: Fitch: AA, Moody's: Aa1, S&P's: AA

Canada (AAA)

Institutions

Bank of Nova Scotia
Ratings: Fitch: AA-, Moody's: Aa1, S&P's: AA-
Royal Bank of Canada

Ratings: Fitch: AA, Moody's: Aaa, S&P's: AA-
Toronto Dominion Bank
Ratings: Fitch: AA-, Moody's: Aaa, S&P's: AA-

Benefits

- Increases flexibility of the Lending options available;
- Only the highest rated banks are considered from those countries who were least affected by the credit crunch and banking crisis and as such are considered low risk and strong performing;
- Included on Sector's Counterparty List (our advisers).

Risks

- Perceived default risk associated with foreign investment though they have no record of any default history;
- May not always be in the market.

3.3 Money Market Funds

The Council could make use of Money Market Funds as part of its Investment Strategy and is viewed essentially as a safe haven for temporary surplus funds. Only Money Market Funds rated AAA MR1+ would be used by the Council, as these funds provide an extremely high degree of security (there has never been a sterling AAA Money Market Fund that has been downgraded since their existence began in the 1970's). The rating is also important as those with MR1+ means that the principal sums invested are guaranteed and would not be open to default risk. As well as providing high security, money market funds have access to a wider range of instruments of higher credit quality than the Council can access. This offers a greater diversification of assets to the Council. Finally the money market funds are extremely liquid and can be accessed on a daily basis if required.

Benefits

- Very Secure – AAA rated which meets Security, Liquidity and Yield (SLY) requirements;
- Very Diversified – invested in a variety of highly rated institutions;
- Very Liquid – on a daily basis it is easy to return and manage these funds;
- Sector (our advisers) also offer a free selection process and as such the Council can have access to a variety of money market funds;
- Can be used when the Council is approaching the counterparty limits as a temporary home for surplus funds.

Risks

- Generally pays a lower rate than can be obtained on the Call Account and other forms of investment - (currently rates vary between 0.5% to 0.8% level);
- Capital Fluctuations – it must be noted that Money Market Funds' underlying assets e.g. Certificates of Deposits, Gilts and other bonds are subject to capital fluctuations and as such there is a small risk that the capital value

may fluctuate. The structure of these arrangements and the guidelines laid down by the credit rating agencies however help to minimise the movement of capital values to a large extent.

4. Recommendations

It is recommended that the Committee:

- Note the amendments made in the Delegated Decision made on 18th May 2010 by the Director of Financial Resources with the agreement of Councillor Dave Allan, the Cabinet Port Folio Holder for Resources
- Consider and approve the proposed options set out in Section 3 above – which will be used to supplement the existing Treasury Management Strategy and Policy Statement for 2010/2011;
- To approve the use of Money Market Funds and to update the Investment Strategy accordingly;
- Recommend to Cabinet the amendments to Treasury Management Strategy and Policy Statement for 2010/2011.

Background Papers

Treasury Management Policy and Strategy Statement 2010/2011 and supporting papers;
Sector Paper on the use of Money Market Funds;
Interest rate projections by various economic forecasters;
Revised CIPFA Treasury Management Code of Practice 2009;
The Financial Times - various editions.

Appendix 1

RECORD OF DECISION MADE UNDER DELEGATED POWERS	
Department:	Office of the Chief Executive - Financial Resources
Officer making Decision:	Director of Financial Resources
Date of decision:	17/05/2010

Nature of decision made:
To amend both the Councils' Lending List Criteria (Appendix H) and the Approved Lending List (limits) set out in (Appendix I) to the report Capital Programme 2010/2011 including Prudential Indicators and Treasury Management Strategy which was agreed and approved by Council on 3rd March 2010 as follows:

Lending List Criteria – amendments:

a) To increase the Maximum Investment Limit for all institutions rated AAA, or AA+ using the Fitch IBCA Long Term Credit Ratings and the equivalent ratings from Standard and Poor's and Moody's (for all those nationalised or part nationalised banks, where the AAA rating for the UK is used, in recognition that the government holds a significant shareholding in these institutions) from a maximum limit of £40m to £50m;
b) To increase the Maximum Investment Limit for all institutions rated AA using the Fitch IBCA Long Term Credit Ratings and the equivalent ratings from Standard and Poor's and Moody's (for all of those major UK based institutions, where the AA rating for the UK is used, in recognition that they are part of the government's guarantee and credit guarantee schemes) from a maximum limit of £30m to £40m; and
c) To increase the Country Limit for all non UK institutions from £30m to £40m.

Approved Lending List – amendments:

a) To increase the Group limits for Lloyds Banking Group and Royal Bank of Scotland Group (and their respective individual institutions making up their groups) from £40m to £50m;
b) To increase the Group Limit for Santander (and their respective individual institutions making up their group, in particular Abbey National Treasury Services plc) from £30m to £40m;
c) To increase the individual limits for Barclays, HSBC, Nationwide Building Society and Standard Chartered Bank from £30m to £40m;
d) To amend Note 1 to Appendix I to reflect the above changes set out in a) to c) above

Reason for decision:
An increase in the limits for all institutions that are AAA or AA+ and also those that are AA rated and included on the Council's Approved Lending is required due to the impact the Investment Strategy agreed by Council on 3rd March 2010 has had on funding levels. This has seen investments placed previously with foreign banks (prior to March 2009) being repatriated back into UK based banks on the maturity of the investment. This policy, together with the level of cash inflows to the Council temporarily increasing and along with the fact that some of the banks listed on the Approved Lending List are either only in the market infrequently or when they are in the market for funds require very high levels of funding but at very low rates of return, has put increasing pressure on the Council to manage its placement of investment funds effectively. The increase in net cash inflows over recent months is seen as a temporary position and has been accurately projected using improved cash flow projections and processes. Cash flows have been carefully monitored over recent months to ensure that decisions can be taken in time to manage out the placement of funds within the existing approved Lending Criteria and the Lending List. The position is being proactively managed and more options may need to be considered by members to further increase flexibility to the existing Treasury Management Strategy and Policy for 2010/2011 to help manage the position moving forward particularly if rescheduled debt needs to be replaced later in the year should market conditions be considered favourable. The timing of debt replacement and debt rescheduling may require a more flexible approach or the need to explore additional options to those set out in the existing Treasury Management Strategy and Policy. A report outlining possible options in this regard is currently being drafted for consideration by the Audit and Governance Committee and Cabinet.

The proposed increases;

- from £40m to £50m to nationalised or part nationalised UK banks is based on the view that these banks are seen as very low risk, as the government has already shown, by acquiring shares in them, that it is not prepared to see these banks fail, and
- from £30m to £40m to those original institutions that can benefit from the governments banking support measures including the Credit Guarantee Scheme, means that the government are in effect 'protecting' these institutions and will also not let them fail and as such are also seen as very low risk.

As a result it is considered that these institutions, already included on the Councils approved Lending List and meeting the Council's Lending Criteria, have a very low default risk.

The Council has only limited space available at this time to place any additional funds and the increase in the proposed limits will help alleviate this position and will also allow a more flexible and effective management of the Council's investments moving forward. These amendments to the Council's Lending List will also allow the Council to take advantage of some attractive higher rate of return investments in UK based institutions that are regarded as being very low risk. The Council's appetite for risk remains low as security of its investment is its main priority, then liquidity and only after these two priorities is yield of return considered. The amendments also mean that all funds will be held with UK based institutions that are considered as being strong organisations and are included on the Lending List approved by Council on 3rd March 2010. The review of these institutions is constantly monitored and funds are held at call (instant withdrawal) or below 365 days duration to ensure funds can be moved as appropriate and opportunities taken in a prudent and measured way.

The above delegated decision will be included in the next Treasury Management report to the Audit and Governance Committee and Cabinet for retrospective approval.

Appendix 1 (Continued)

Members/Officers consulted (attach their views as appropriate)	Cllr D. Allan
File/background papers used:	See Attached for copy of report approved by Council on 3rd March 2010 and 4th March 2009 which confirms the authority bestowed on the Director of Financial Resources for this type of delegated decision.
Is this a confidential matter as referred to in paragraph 7 of the Guidance?	No
Paragraph of Delegation Scheme relied upon:	Council approved on 4th March 2009 that "delegated authority be given to the City Treasurer, (now Director of Financial Resources), in consultation with the Cabinet Port folio holder for Resources, to vary the Lending List Criteria and the Lending List should circumstances dictate, on the basis that changes be reported to Cabinet retrospectively".

Signature:………………………………………………………... **Date:………………**

Counter Signature:………………………………………………… **Date:………………**

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	50	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	364 Days

Money Market Funds

Maximum amount to be invested in Money Market Funds is £50 million with a maximum of £10 million in any one fund.	30	2 Years

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	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	250
Local Government	250
UK Banks	250
UK Building Societies	150
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 3.

Approved Lending List

Appendix 3

	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 50**	
Lloyds Banking Group plc	AA-	F1+	C	1	A1	-	-	A	A-1	50	364 days
Lloyds TSB Bank Plc	AA-	F1+	C	1	Aa3	P-1	C-	A+	A-1	50	364 days
Bank of Scotland Plc	AA-	F1+	C	1	Aa3	P-1	D+	A+	A-1	50	364 days
Royal Bank of Scotland Group (See Note 1)										**Group Limit 50**	
Royal Bank of Scotland Group plc	AA-	F1+	D/E	1	A1	-	-	A	A-1	50	364 days
The Royal Bank of Scotland Plc	AA-	F1+	D/E	1	Aa3	P-1	C-	A+	A-1	50	364 days
National Westminster Bank Plc	AA-	F1+	-	1	Aa3	P-1	C-	A+	A-1	50	364 days
Ulster Bank Ltd	A+	F1+	E	1	A2	P-1	D-	A	A-1	50	364 days
Santander Group *										**Group Limit 40**	
Santander UK plc	AA-	F1+	B	1	Aa3	P-1	C-	AA	A-1+	40	364 days
Abbey National Treasury Services plc	AA-	F1+	-	-	Aa3	P-1	-	-	-	40	364 days
Alliance and Leicester plc	AA-	F1+	B	1	Aa3	P-1	E+	AA	A-1+	40	364 days
Barclays Bank plc *	AA-	F1+	B	1	Aa3	P-1	C	AA-	A-1+	40	364 days
HSBC Bank plc *	AA	F1+	B	1	Aa2	P-1	C+	AA	A-1+	40	364 days

Appendix 3 (continued)

	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
Nationwide BS *	AA-	F1+	B	1	Aa3	P-1	C-	A+	A-1	40	364 days
Standard Chartered Bank *	A+	F1	B	1	A2	P-1	C+	A+	A-1	40	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 ***	BBB+	F2	C	2	-	-	-	A-	A-2	0	
Top 10 Building Societies (by asset value)											
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
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	
Stroud & Swindon BS ***	Not Rated	-	-	-	-	-	-	-	-	0	
Foreign Banks have a combined total limit of £40m											
Australia	AA+	-	-	-	Aaa	-	-	AAA			
National Australia Bank	AA	F1+	B	1	Aa1	P-1	B	AA	a-1+	40	364 Days
Australia and New Zealand Banking Group Ltd	AA-	F1+	B	1	Aa1	P-1	B	AA	a-1+	20	364 Days

Appendix 3 (continued)											
	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
Commonwealth Bank of Australia	AA	F1+	A/B	1	Aa1	P-1	B	AA	a-1+	40	364 Days
Westpac Banking Corporation	AA	F1+	A/B	1	Aa1	P-1	B	AA	a-1+	40	364 Days
Canada	**AAA**				**Aaa**			**AAA**			
Bank of Nova Scotia	AA-	F1+	B	1	Aa1	P-1	B	AA-	A-1+	20	364 Days
Royal Bank of Canada	AA	F1+	A/B	1	Aaa	P-1	B+	AA-	A-1+	20	364 Days
Toronto Dominion Bank	AA-	F1+	B	1	Aaa	P-1	B+	AA-	A-1+	20	364 Days

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