Sunderland City Council

Item No. 4

AUDIT AND GOVERNANCE COMMITTEE **12 DECEMBER 2014**

TREASURY MANAGEMENT – THIRD QUARTERLY REVIEW 2014/2015

Report of the Director of Finance

1. Purpose of Report

1.1 To report on the Treasury Management (TM) performance to date for the third quarter of 2014/2015.

2. Description of Decision

2.1 The Committee is requested to:

- Note the Treasury Management performance during Quarter 3 of 2014/2015.

- Note the Lending List Criteria at Appendix B and the updated Approved Lending List at Appendix C.

3. Introduction

3.1 This report sets out the Treasury Management performance to date for the third quarter of the financial year 2014/2015, in accordance with the requirements of the Treasury Management Policy and Strategy agreed by Council.

4. Summary of Treasury Management Performance for 2014/2015 – Quarter 3

4.1 The Council's Treasury Management function continues to look at ways to maximise financial savings and increase investment return to the revenue budget. There was a large fall in PWLB borrowing rates in July, August and October as investors sought lower risk investment options following the escalation of the conflict in Ukraine and expectations of further banking interventions within the Eurozone. As PWLB rates were at a historically low level, it was decided to take advantage of these rates, to support the Council's Capital Programme requirements, and borrow £20m in Quarter 2 and a further £10m in Quarter 3. This will help maintain the Council's long term borrowing interest rate at its comparatively low level and will benefit the Council's revenue budget over the longer term.

4.2 One option to make savings is through debt rescheduling, however no rescheduling has been possible in 2014/15 as rates have not been considered sufficiently favourable. It should be noted the Council's interest rate on borrowing continues to be very low, currently 3.34%, and as such the Council benefits from this lower cost of borrowing and also from the ongoing savings from past debt rescheduling exercises. Performance continues to see the Council's rate of borrowing in the lowest quartile as compared to other authorities.

4.3 Treasury Management Prudential Indicators are regularly reviewed and the Council is within the limits set for all of its TM Prudential Indicators. The statutory limit under section 3(1) of the Local Government Act 2003, which is required to be reported separately, (also known as the Authorised Borrowing Limit for External Debt) was set at £440.123m for 2014/2015. The Council's maximum borrowing position at 30th November 2014 was £227.171m and is well within this limit. More details of all of the TM Prudential Indicators are set out in section A2 of Appendix A for information.

4.4 The Council's investment policy is regularly monitored and reviewed to ensure it has flexibility to take full advantage of any changes in market conditions which will benefit the Council.

4.5 As at 30th November 2014, the funds managed by the Council's Treasury Management team have achieved a rate of return on its investments of 0.75% compared with the benchmark 7 Day LIBID (London Interbank Bid) rate of 0.35%. Performance is positive and is significantly above the benchmark rate, whilst still adhering to the prudent policy agreed by the Council, in what remains a very challenging market.

4.6 The rate of return on investments, as previously reported, has remained at very low levels compared to previous years, mainly due to UK-based financial institutions having accessed funding from alternative sources (such as the Government's Funding for Lending Scheme) to increase their capital/cash reserves in line with revised regulatory requirements. Consequently demand for local authority funds is low and whilst interest rates have improved slightly there is little prospect of a significant upturn until the Bank of England begin to increase the Base Rate. Even special tranche investment rates (which offer better than market average returns) have followed this downward trend. The implication is that the return on investments will be below those achieved in recent years.

Interest rates are being carefully monitored with short-term investments made where necessary so that the council can take full advantage of the expected increase in rates when it does occur.

4.7 More detailed Treasury Management information is included in Appendix A for Members' information.

4.8 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 since the last report. The updated Approved Lending List is shown in Appendix C for information.

5. Recommendation

5.1 Members are requested to note the Treasury Management (TM) performance for the third quarter of 2014/2015.

5.2 Members are requested to note the Lending List Criteria at Appendix B and the updated Approved Lending List at Appendix C.

Appendix A

Detailed Treasury Management Performance – Quarter 3 2014/2015

A1 Borrowing Strategy and Performance – 2014/15

A1.1 The Borrowing Strategy for 2014/2015 was reported to Cabinet on 12th February 2014 and approved by full Council on 5th March 2014.

The Borrowing Strategy is based upon interest rate forecasts from a wide cross section of City institutions. The view in February 2014, when the Treasury Management Policy and Strategy was drafted, was that the Bank Base Rate would remain at 0.50% until March 2016 before steadily rising to 1.25% by March 2017 and that PWLB borrowing rates would increase during 2014/2015 across all periods.

The Bank Base Rate has remained at an all-time low of 0.50% since March 2009 with monetary policy set by the Bank of England (BoE) to meet a 2% inflation target in the medium-term. Recent economic data suggests a slowdown in the pace of recovery without the need for further Bank of England intervention, a view backed by November's Inflation Report where both growth and inflation expectations have been revised lower.

Financial analysts continue to push back their timing of an increase in the current Bank Rate, some as late as Q1 2016. Most do not anticipate a rise until at least the second quarter of 2015, a view shared by the Council's economic advisers Capita Asset Services, with rates then increasing gradually for the following two years and reaching 2.0% in Q3 2017.

Forecasts for PWLB interest rate levels have fallen across the board with benchmark rates of 2.5% for 5 years, 3.2% for 10 years and 3.9% for 25 and 50 years. Significant geopolitical risks and risks from the Eurozone continue to weigh on financial markets with this volatility expected to continue over the coming months.

The following table shows the average PWLB rates for Quarters 1 to 3 to date.

2014/2015	Qtr 1* (Apr - Jun) %	Qtr 2* (Jul – Sept) %	Qtr 3* (Oct - Nov) %
7 days notice	0.35	0.35	0.35*
1 year	1.29*	1.43*	1.26*
5 year	2.66*	2.70*	2.30*
10 year	3.56*	3.45*	3.01*
25 year	4.22*	4.04*	3.69*
50 year	4.18*	4.01*	3.70*

*rates take account of the 0.20% discount to PWLB rates available to eligible authorities (which came into effect on 1st November 2012).

A1.2 The strategy for 2014/2015 is to adopt a pragmatic approach in identifying the low points in the interest rate cycle at which to borrow, and to respond to any changing circumstances to seek to secure benefit for the Council. A benchmark financing rate of 5.00% for long-term borrowing was set for 2014/2015 in light of the views prevalent at the time the Treasury Management policy was set in March 2014. Recent volatility in the financial markets has seen considerable movement of funds into gilts with a resulting fall in both gilt yields and PWLB rates which the Council has taken advantage of. Investors have sought safer investment options following the conflict in Ukraine and more recently expectations of low inflation and economic growth that will require possible further financial support measures within the Eurozone. In line with discussions with the Council's economic advisors, the Council has sought to take advantage of the low borrowing rate troughs that have occurred particularly over the past 4 months, which will benefit the revenue budget over the longer term. As a result the Council has taken out £30 million of new borrowing during the financial year as these rates were considered opportune at each point in time. The new borrowing is summarised in the following table:

Duration	**Date of the transaction**	**Start**	**Matures**	**Rate %**	**Loan Amount £m**
50 years	08/08/2014	12/08/2014	12/08/2064	3.84	10.0
50 years	29/08/2014	02/09/2014	02/09/2064	3.72	10.0
50 years	16/10/2014	20/10/2014	20/10/2064	3.54	10.0

Since taking out this new borrowing, rates have fluctuated and lower inflation expectations have pushed rates downwards. The position is quite volatile at the moment and the Treasury Management team continues to closely monitor PWLB rates to assess the value of possible further new borrowing in line with the Authority's future Capital Programme requirements.

A1.3 The Borrowing Strategy for 2014/2015 made provision for debt rescheduling but due to 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.

Rates have not been sufficiently favourable for rescheduling in 2014/2015 so far and the Treasury Management team will continue to monitor market conditions and secure early redemption if appropriate opportunities should arise.

The Council successfully applied to access PWLB loans at a discount of 0.20%. This 'certainty rate' is available for those authorities that provide "improved information and transparency on their locally determined long-term borrowing and associated capital spending plans". The discount came into effect on 1st November 2012 and the Council has been successful in extending its access to the PWLB certainty rate until at least 31st October 2015.

A1.4 The Council's treasury portfolio position at 30th November 2014 is set out below:

		Principal (£m)	**Total (£m)**	**Average Rate (%)**
Borrowing				
Fixed Rate Funding	PWLB	157.9		
	Market	39.6		
	Other	2.0	199.5	3.75
Variable Rate Funding	Temporary / Other		27.6	0.41
Total Borrowing			**227.1**	**3.34**

A2 Treasury Management Prudential Indicators – 2014/2015

A2.1 All external borrowing and investments undertaken in 2014/2015 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 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 2014/2015 as follows:

	£m
Borrowing	410.945
Other Long-Term Liabilities	29.178
Total	**440.123**

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

	£m
Borrowing	302.575
Other Long Term Liabilities	29.178
Total	**331.753**

The maximum external debt in respect of borrowing in 2014/15 (to 30th November 2014) was £256.349 million (which includes borrowing in respect of other organisations such as Tyne and Wear Fire and Rescue Authority and 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 key indicators.

A2.3 The table below shows that all other Treasury Management Prudential Indicators have been complied with:

Prudential Indicators		**2014/2015 (to 30/11/14)**	
		Limit £'000	**Actual £'000**
P10	**Upper limit for fixed interest rate exposure**		
	Net principal re fixed rate borrowing / investments	250,000	90,181
P11	**Upper limit for variable rate exposure**		
	Net principal re variable rate borrowing / investments	60,000	-10,271
P12	**Maturity Pattern**	Upper Limit	
	Under 12 months	50%	19.57%
	12 months and within 24 months	60%	0.66%
	24 months and within 5 years	80%	4.60%
	5 years plus	100%	82.21%
	A lower limit of 0% for all periods		
P13	**Upper limit for total principal sums invested for over 364 days**	75,000	0

A3 Investment Strategy – 2014/2015

A3.1 The Investment Strategy for 2014/2015 was approved by Council on 5th March 2014. 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 30th November 2014, the funds managed by the Council's in-house team amounted to £199.383 million and all investments complied with the Annual Investment Strategy. This includes monies invested on behalf of all other external organisations. The table below shows the return received on these investments compared with the benchmark 7 Day LIBID (London Interbank Bid) rate, which the Council uses to assess its performance.

	2014/2015 Actual to 30/11/14 %	**2014/2015 Benchmark to 30/11/14 %**
Return on investments	0.75	0.35

A3.3 Investments placed in 2014/2015 have been made in accordance with the approved investment strategy and comply with the Counterparty Criteria in place, shown in Appendix B, which is used to identify organisations on the Approved Lending List.

A3.4 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 Council's advantage.

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 Eurozone, advice from our Treasury Management advisers is to continue to restrict investments with all financial institutions to shorter term periods.

A3.7 Advice also continues that the above guidance is not applicable to institutions considered to be very low risk, mainly where the government holds shares in these organisations (i.e. Lloyds and RBS) which have an AA+ rating applied to them, or separately in respect of Money Market Funds which are in fact 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. Members should also note that Swedish Bank, Svenska Handelsbanken has been added to the list of approved institutions that the Council can invest with. The Swedish state holds the highest possible AAA rating combined with a stable outlook from all three leading credit ratings agencies, whilst the credit rating for Svenska Handelsbanken is at the same level as HSBC and higher than all other UK banks. Since 2000 Svenska Handelsbanken has been steadily building up a UK branch network, including a Sunderland branch, and its addition to the Approved Lending List will increase the investment options, with highly rated counterparties, available to the Council. The Approved Lending List is shown in Appendix C and has been updated with notified changes to credit ratings.

Lending List Criteria **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 advisers.

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	110	2 Years
AA+	F1+	A1+	Aa1	P-1	90	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)					90	2 years
Money Market Funds Maximum amount to be invested in Money Market Funds is £80m with a maximum of £40m in any one fund.					80	Liquid Deposits
Local Authority controlled companies (# duration limited to 20 years in accordance with Capital Regulations)					20	# 20 years

Where the UK Government holds a shareholding in an institution the UK Government's credit rating of AA+ 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 £350m 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	350
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	350
Local Government	350
UK Banks	350
UK Building Societies	150
Money Market Funds	80
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 AA+; and
- that market intelligence and professional advice is taken into account.

Proposed group limits are set out in Appendix C.

Approved Lending List **Appendix C**

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Viability	Support	L Term	S Term	Fin Strength Rating	L Term	S Term	Limit £m	Max Deposit Period
UK	AA+	-	-	-	Aa1	-	-	AAA	-	350	2 years
Lloyds Banking Group (see Note 1)										**Group Limit 90**	
Lloyds Banking Group plc	A	F1	a-	1	A2	-	-	A-	A-2	90	2 years
Lloyds Bank Plc	A	F1	a-	1	A1	P-1	C-	A	A-1	90	2 years
Bank of Scotland Plc	A	F1	a-	1	A1	P-1	C-	A	A-1	90	2 years
Royal Bank of Scotland Group (See Note 1)										**Group Limit 90**	
Royal Bank of Scotland Group plc	A	F1	bbb	1	Baa2	P-2	-	BBB+	A-2	90	2 years
The Royal Bank of Scotland Plc	A	F1	bbb	1	Baa1	P-2	D+	A-	A-2	90	2 years
National Westminster Bank Plc	A	F1	bbb	1	Baa1	P-2	D+	A-	A-2	90	2 years
Ulster Bank Ltd	A-	F1	ccc	1	Baa3	P-3	E+	BBB+	A-2	90	2 years
Santander Group *										**Group Limit 40**	
Santander UK plc	A	F1	a	1	A2	P-1	C-	A	A-1	40	364 days
Cater Allen	-	-	-	-	-	-	-	-	-	40	364 days
Barclays Bank plc *	A	F1	a	1	A2	P-1	C-	A	A-1	40	364 days
HSBC Bank plc *	AA-	F1+	a+	1	Aa3	P-1	C	AA-	A-1+	40	364 days

Appendix C

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Viability	Support	L Term	S Term	Fin Strength Rating	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-	**A+**	**A-1**	40	364 days
Clydesdale Bank / Yorkshire Bank **/***	A	F1	bbb+	1	Baa2	P-2	D+	BBB+	A-2	0	
Co-Operative Bank Plc	B	B	b	5	Caa2	NP	E	-	-	0	
Top Building Societies (by asset value)											
Nationwide BS (see above)											
Yorkshire BS ***	**A-**	**F1**	**a-**	5	Baa1	P-2	C-	-	-	0	
Coventry BS	A	F1	a	5	A3	P-2	C	-	-	5	6 Months
Skipton BS ***	**BBB**	**F2**	**bbb**	5	**Baa3**	**P-3**	D+	-	-	0	
Leeds BS	A-	**F1**	a-	5	A3	P-2	C	-	-	5	6 Months
West Bromwich BS ***	-	-	-	-	B2	NP	E+	-	-	0	
Principality BS ***	BBB+	F2	bbb+	5	**Baa3**	**P-3**	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+	20	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+	20	364 Days
Westpac Banking Corporation	AA-	F1+	aa-	1	Aa2	P-1	B-	AA-	A-1+	20	364 Days

Appendix C

	Fitch				Moody's			Standard & Poor's			
	L Term	S Term	Viability	Support	L Term	S Term	Fin Strength Rating	L Term	S Term	Limit £m	Max Deposit Period
Canada	AAA	-	-	-	Aaa	-	-	AAA	-	40	364 Days
Bank of Nova Scotia	AA-	F1+	aa-	1	Aa2	P-1	B-	A+	A-1	10	364 Days
Royal Bank of Canada	AA	F1+	aa	1	Aa3	P-1	C+	AA-	A-1+	20	364 Days
Toronto Dominion Bank	AA-	F1+	aa-	1	Aa1	P-1	B	AA-	A-1+	20	364 Days
Sweden	AAA	-	-	-	Aaa	-	-	AAA	-	40	364 Days
Svenska Handelsbanken AB	AA-	F1+	aa-	1	Aa3	P-1	C	AA-	A-1+	20	364 Days
Money Market Funds										80	Liquid
Prime Rate Stirling Liquidity	AAA				Aaa			AAA		40	Liquid
Insight Liquidity Fund	AAA							AAA		40	Liquid
Ignis Sterling Liquidity	AAA							AAA		40	Liquid
Deutsche Managed Sterling Fund	-	-	-	-	Aaa	-	-	AAA	-	40	Liquid

Notes

Note 1 **Nationalised / Part Nationalised**
The counterparties in this section will have the UK Government's AA+ rating applied to them thus giving them a credit limit of £90m.

* Banks / Building Societies which are part of the UK Government's Credit Guarantee scheme
The counterparties in this section will have an AA rating applied to them thus giving them a credit limit of £40 million

** 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.