Sunderland City Council

Item No. 6

AUDIT AND GOVERNANCE COMMITTEE **29 June 2012**

TREASURY MANAGEMENT – REVIEW OF PERFORMANCE 2011/2012

Report of the Executive Director of Commercial and Corporate Services

1 **Purpose of the Report**

1.1 To report on the Treasury Management borrowing and investment performance for 2011/2012.

2 **Description of Decision**

2.1 The committee is requested to note the positive Treasury Management performance for 2011/2012.

3 **Introduction**

3.1 This report sets out the annual borrowing and investment performance for the financial year 2011/2012 in accordance with the requirements of the Treasury Management Policy Statement and Treasury Management Strategy approved by Council on 2nd March 2011. The Treasury Management Strategy comprises the approved Council strategy for borrowing and its policies for managing its investments, (which give priority to the security and liquidity of those investments).

3.2 The Policy Statement and Strategy complies with best practice, including the Department of Communities and Local Government Investment Guidance which came into effect from 1st April 2010 and it incorporates the recommendations included in the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management. The Code of Practice was revised in November 2011 mainly to accommodate the changes to local authority housing finance regulations.

4 **Review of Performance 2011/2012**

4.1 **Summary**

The performance of the Council's Treasury Management function continues to contribute significant financial savings that are used to provide funding to support the Council's revenue budget. The average rate of the Council's borrowing at 3.46% is in the top quartile when benchmarked against other authorities as is the rate of return achieved on investments. In 2011/2012 this has meant a saving of almost £1.9 million to the original 2011/2012 investment income budget and a saving on debt charges of over £4.0m for the year.

Borrowing Strategy and Performance – 2011/2012

4.2 The basis of the agreed Borrowing Strategy was to:

- continuously monitor prevailing interest rates and forecasts;
- secure long-term funds to meet the Council's future borrowing requirement when market conditions were favourable;
- use a benchmark financing rate of 5.50% for long term borrowing (i.e. all borrowing for a period of one year or more);
- take advantage of debt rescheduling opportunities as appropriate.

4.3 The Borrowing Strategy has been reviewed regularly by this committee in June and September 2011 and also in February 2012 and was updated where necessary to reflect changing circumstances. The Borrowing Strategy for 2011/2012 was based upon the views of the Executive Director of Commercial and Corporate Services, supplemented with market data, market information and leading economic forecasts provided by the Council's treasury adviser, Sector Treasury Services.

4.4 The view in February 2011, at the time the Treasury Management Policy and Strategy was drafted, was that variable rate borrowing was expected to become more expensive. 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 also 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 around 5.3%.

Economists are now forecasting that the first increase in the bank base rate will be in the first quarter of 2014. 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

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 £50bn 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 was a much greater concern than inflation. The prospect of further quantitative easing as a result can not be ruled out.

2. The marked deterioration of growth prospects in the major world economies such as Spain. Even though the UK has moved into a double dip recession this has led 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 meant forecasts for PWLB rates were much higher than the actual rates experienced during the year and the expectation of the timing of the eventual start of increases in the bank base rate and PWLB rates are now substantially longer into the future..

The table below shows the average borrowing rates in 2011/2012.

2011/2012	Qtr 1 (Apr - June) %	Qtr 2 (July – Sept) %	Qtr 3 (Oct – Dec) %	Qtr 4 (Jan – Mar) %
7 days notice	0.40	0.38	0.37	0.35
1 year	1.69	1.50	1.39	1.30
5 year	3.29	2.59	2.25	2.05
10 year	4.51	3.82	3.33	3.19
25 year	5.22	4.84	4.22	4.19
50 year	5.16	4.88	4.28	4.24

Reductions in gilt yields to historic lows have led to reductions in PWLB borrowing rates during 2011/2012. However, these reductions should have been greater. The Government's October 2010 Spending Review instructed the PWLB to increase the interest rate on all new loans by an average of 1.00% above the Government's cost of borrowing. This unexpected increase across all PWLB rates of 0.87% made borrowing from this source more expensive overnight and also made debt rescheduling opportunities less likely. In the March 2012 Budget the government announced that PWLB rates may be decreased by 0.2% under certain circumstances and as such the Council is keeping a watching brief on this in order to take advantage of this concession should the opportunity arise. The government has yet to provide detailed guidance on how this reduced rate can be acquired.

4.5 The Council borrowed £10.0 million from the PWLB in 2011/2012 as set out in the table below. The interest rate payable on the new loan was 3.99% and well below the 5.50% target rate set for long-term borrowing, representing an ongoing lower cost of borrowing to the Council. The rate achieved is also well below the average rates for 50 year PWLB loans set out in the above table at paragraph 4.4.

Long Term Borrowing 2011/2012						
Date	**Lender**	**Amount £m**	**Period (Years)**	**Rate %**	**Benchmark Rate %**	**Margin %**
20/01/12	PWLB	10.0	50	3.99	5.50	1.51

4.6 The Treasury Management Strategy included provision for debt rescheduling should appropriate opportunities arise. However, the October 2010 PWLB borrowing rate increase was not accompanied by an increase in early debt redemption rates. This, and the very low underlying rate of the Council's long-term debt (arising from the proactive approach to debt rescheduling and borrowing taken by the Council in recent years), has meant that rates have not been sufficiently favourable to undertake further debt rescheduling in 2011/2012. Market conditions however will continue to be monitored to identify and take advantage of any such opportunities should they arise.

4.7 The Council's borrowing portfolio position at 31st March 2012 is set out below:

		Principal (£m)	Total (£m)	Average Rate (%)
Borrowing				
Fixed Rate Funding	PWLB	148.0		
	Market	24.5		
	Other	0.3	172.8	3.84
Variable Rate Funding	Market	15.0		
	Temporary / Other	29.8	44.8	1.99
Total Borrowing			**217.6**	**3.46**
Total Investments *	All managed In-House		**231.5**	**1.62**
Net Investments			**13.9**	

* Total investments includes monies invested on behalf of the North Eastern Local Enterprise Partnership for whom Sunderland City Council is the accountable body

Prudential Indicators – 2011/2012

4.8 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 also report on the Council's performance for all of the other Prudential Indicators as follows:

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 2011/2012 in total as £382.399m which was detailed as follows:

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

The Operational Boundary for External Debt for 2011/2012 was set at £312.463m as follows:

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

Both the Authorised Limit and the Operational Limit include an element for long-term liabilities relating to PFI schemes and finance leases. These have been brought onto the Council's Balance Sheet in compliance with International Financial Reporting Standards (IFRS).

The Council's maximum borrowing level in 2011/2012 was £219.424 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.

4.9 The table below shows that all other Treasury Management Prudential Indicators have been complied with during 2011/2012.

Prudential Indicators		2011/2012	
		Limit £'000	**Actual £'000**
P10	**Upper limit for fixed interest rate exposure** Net principal re fixed rate borrowing / investments	105,000	47,553
P11	**Upper limit for variable rate exposure** Net principal re variable rate borrowing / investments	60,000	26,173
P12	**Maturity Pattern**	Upper Limit	
	Under 12 months	50%	16.7%
	12 months and within 24 months	60%	2.4%
	24 months and within 5 years	80%	7.3%
	5 years plus	100%	77.1%
	A lower limit of 0% for all periods		
P13	**Upper limit for total principal sums invested for over 364 days**	100,000	0

The Council is currently within the limits set for all of its Treasury Management Prudential Indicators.

5. Investment Strategy and Performance – 2011/2012

5.1 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.

The Annual Investment Strategy has been fully complied with in 2011/2012.

5.2 At 31st March 2012, the Council had outstanding investments of £231.5 million. The table below shows the return made on the Council's total investments for 2011/2012 as compared with the benchmark 7 Day LIBID (London Interbank Bid) rate, which the Council uses to assess its performance.

	2011/2012 Return %	2011/2012 Benchmark %
In-house Managed Funds	**1.62**	**0.49**

This return far exceeded the benchmark set for 2011/2012 and represents a very good achievement especially when short-term investment rates continued to remain very low throughout the year.

5.3 All investments placed in 2011/2012 have been made in accordance with the approved Criteria and the Approved Lending List by Council on 2nd March 2011 and to any subsequent revisions approved by Cabinet during the year. Investments placed in 2011/2012 have been made in accordance with the approved investment strategy and comply with the counterparty criteria used to identify financial organisations on the Approved Lending List.

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. Investment rates available in the market have continued at historically low levels and due to the continuing high volatility within the financial markets, particularly in the euro zone, and advice from our Treasury Management advisers is to restrict investments to all financial institutions to shorter term periods.

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

5.4 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. Changes made during 2011/2012 have already been reported to members previously and the latest Lending List and Criteria are included in the Treasury Management First Quarterly Review 2012/2013 reported to this meeting..

6. Reasons for Decisions

6.1 To note the performance for 2011/2012.

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
The Prudential Code for Capital Finance
CIPFA Code of Practice on Treasury Management in Local Authorities
The Financial Times
Other financial websites