Sunderland City Council

**Item No. 10**

**AUDIT AND GOVERNANCE COMMITTEE** **13 December 2013**

**TREASURY MANAGEMENT – THIRD QUARTERLY REVIEW 2013/2014**

**Report of the Head of Financial Resources**

## 1. Purpose of Report

1.1 To report on the Treasury Management (TM) performance for the third quarter of 2013/2014.

## 2. Description of Decision

2.1 The Committee is requested to note the Treasury Management performance during Quarter 3 of 2013/2014.

2.2 To note amendments (bold type) to the 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 2013/2014, in accordance with the requirements of the Treasury Management Policy and Strategy agreed by Council on 6th March 2013.

## 4. Review of Treasury Management Performance for 2013/14 – Quarter 3

4.1 The Council's Treasury Management function continues to look at ways of maximising financial savings and increase investment return to the revenue budget. One option to make savings is through debt rescheduling, however no rescheduling has been possible in 2013/2014 as rates have not been considered sufficiently favourable. It should be noted however the Council's interest rate on borrowing is very low, currently 3.48%, as the Council continues to benefit from this low cost of borrowing which reflects savings from past debt rescheduling exercises and other proactive Treasury Management activity.

4.2 Treasury Management (TM) 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 £398.602m for 2013/2014 and the Council 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.

4.3 The 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.

4.4 As at 30th November 2013, the funds managed by the Council's Treasury Management team have achieved a rate of return on its investments of 1.04% compared with the benchmark 7 Day LIBID (London Interbank Bid) rate of 0.36%. Performance is very positive and is significantly above the benchmark rate, whilst still adhering to the prudent policy agreed by the Council, although market conditions remain challenging.

4.5 The rate of return on investments has fallen markedly in recent months as UK-based financial institutions access funding from alternative sources such as the Government's Funding for Lending Scheme to increase their capital/cash reserves in line with recent regulatory requirements. The result is that investment rates have reduced considerably since April 2013 and still continue to follow a downward trend. Even special tranche investment rates (which offer better than market average returns) have reflected this downward trend. Forward guidance announced in the Bank of England's Quarterly Inflation report (November 2013) shows that whilst unemployment may fall to 7% during 2015, this would not automatically trigger any increase in the Bank Base Rate. The implication of this is that returns on investments will be significantly lower than those achieved in recent years until interest rates begin to rise which is now estimated as being mid year 2015 at the very earliest although some including the Council's advisors predict mid year 2016. This position helps to show how uncertain the financial markets are expected to perform in the medium term at the moment.

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

4.7 The regular updating of the Council's authorised lending list takes into account all recent financial institution mergers and amendments to institutions' credit ratings. The Approved Lending List as detailed in Appendix C has been updated to reflect these changes.

## 5. Recommendation

5.1 Members are requested to note the Treasury Management (TM) performance for the third quarter of 2013/2014.

5.2 Members are requested to note amendments to the Approved Lending List at Appendix C.

**Appendix A**

## Detailed Treasury Management Performance – Quarter 3 2013/14

### A1 Borrowing Strategy and Performance – 2013/14

A1.1 The Borrowing Strategy for 2013/2014 was reported to Cabinet on 13th February 2013 and approved by full Council on 6th March 2013.

The Borrowing Strategy is based upon interest rate forecasts from a wide cross section of City institutions. The view in February 2013, when the Treasury Management Policy and Strategy was drafted, was that the Bank Base Rate would remain at 0.50% until December 2014 before steadily rising to 1.75% by March 2016 and that PWLB borrowing rates would increase during 2013/2014 across all periods.

The Bank of England's November Quarterly Inflation report has revised its view of the economy since August to offer a more upbeat assessment of the UK economic recovery. As a consequence of the ongoing improved data, growth forecasts have increased from 1.4% to 1.6% for 2013 and from 2.5% to 2.8% for 2014. However, there are still reasons to believe that economic recovery may not necessarily translate to employment growth at the rate financial markets are expecting. The Bank has an unemployment threshold of 7% as the point at which it would consider an increase in the current 0.5% Base Rate (in place since March 2009). At this point, any decision would also be dependant upon forecasts for inflation and growth.

The headline CPI inflation figure fell to 2.2% in October and analysts anticipate this downward trend will continue. The Bank of England now forecast inflation to fall to around the 2% target over the next year or so. Problems persist within the Eurozone, the UK's largest trading partner, where political unease over the scale and pace of austerity measures continues. Unemployment levels in the region are expected to remain at their current historic highs in all but a few countries. In addition the price of oil is vulnerable to geo-political events such as the ongoing unrest in parts of the Middle East.

During 2013/2014 there has been a sharp rise in UK gilt yields which has led to an increase in PWLB rates as investors have switched from bonds into equities, with share markets now standing at or near new highs. Potential upside risks for further increases remain, especially for longer term PWLB rates, as follows:

- UK inflation remains significantly higher than in the wider EU and US.
- A reversal of Quantitative Easing, either by allowing gilts to mature without being replaced or sale of gilts currently held.
- A reversal in Sterling's safe haven status following financial improvements in the Eurozone.
- Further increase in investor confidence causing continued flow of funds out of bonds and into equities.

However, bond yields remain extremely unpredictable and there are still exceptional levels of volatility which are highly correlated to the sovereign debt crisis and to political developments in the Eurozone and the US. This uncertainty is expected to continue into the medium term.

As a consequence of the Bank of England forward guidance and expectations of continued recovery in the UK economy, financial markets are expecting a first increase in Bank Rate in the second quarter of 2015. However, the Council's treasury advisor Capita Asset Services (formerly Sector Treasury Services) does not anticipate any movement in the rate until the second quarter of 2016, 12 months later.

The following table shows the average PWLB rates for Quarters 1, 2 and 3.

| **2013/2014** | **Qtr 1* (Apr - June) %** | **Qtr 2* (July - Sep) %** | **Qtr 3* (Oct – Nov) %** |
|---|---|---|---|
| 7 days notice | 0.31 | 0.31 | 0.35 |
| 1 year | 1.02* | 1.07* | 1.12* |
| 5 year | 1.75* | 2.27* | 2.36* |
| 10 year | 2.81* | 3.47* | 3.52* |
| 25 year | 3.95* | 4.32* | 4.28* |
| 50 year | 4.09* | 4.37* | 4.29* |

*rates take account of the 0.2% discount to PWLB rates available to eligible authorities that came into effect on 1st November 2012.

A1.2 The strategy for 2013/2014 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 4.50% for long-term borrowing was set for 2013/2014. Due to high levels of volatility in the financial markets, no new borrowing has been undertaken in the current financial year up to 30th November 2013, but this position will be kept under review.

A1.3 The Borrowing Strategy for 2013/2014 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.

Interest rates have not been sufficiently favourable for rescheduling in 2013/2014 and are not expected to rise to a level that would make rescheduling a viable option until the medium term. The Treasury Management team will continue to monitor market conditions and secure early redemption if appropriate opportunities arise. Any rescheduling undertaken will be reported to Cabinet in line with the current Treasury Management reporting procedures.

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 31st October 2014.

A1.4 The Council's treasury portfolio position at 30th November 2013 is set out below:

| | | Principal (£m) | Total (£m) | Average Rate (%) |
|---|---|---|---|---|
| **Borrowing** | | | | |
| Fixed Rate Funding | PWLB | 137.9 | | |
| | Market | 39.5 | | |
| | Other | 1.7 | 179.1 | 3.95 |
| Variable Rate Funding | Temporary / Other | | 28.2 | 0.54 |
| **Total Borrowing** | | | **207.3** | **3.48** |

## A2 Treasury Management Prudential Indicators – 2013/2014

A2.1 All external borrowing and investments undertaken in 2013/2014 have been subject to the rigorous 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 2013/2014 as follows:

| | **£m** |
|---|---|
| Borrowing | 366.139 |
| Other Long-Term Liabilities | 32.463 |
| **Total** | **398.602** |

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

| | **£m** |
|---|---|
| Borrowing | 322.863 |
| Other Long-Term Liabilities | 32.463 |
| **Total** | **355.326** |

The maximum external debt in respect of borrowing in 2013/14 (to 30th November 2013) was £213.106 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 approved in March 2013 have been complied with:

| **Prudential Indicators** | | **2013/2014 (to 30/11/13)** | |
|---|---|---|---|
| | | **Limit £'000** | **Actual £'000** |
| **P10** | **Upper limit for fixed interest rate exposure** | | |
| | Net principal re fixed rate borrowing / investments | 235,000 | 74,070 |
| **P11** | **Upper limit for variable rate exposure** | | |
| | Net principal re variable rate borrowing / investments | 50,000 | -35,812 |
| **P12** | **Maturity Pattern** | Upper Limit | |
| | Under 12 months | 50% | 16% |
| | 12 months and within 24 months | 60% | 5% |
| | 24 months and within 5 years | 80% | 3% |
| | 5 years plus | 100% | 79% |
| | 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 – 2013/2014

A3.1 The Investment Strategy for 2013/2014 was approved by Council on 6th March 2013. 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 2013, the funds managed by the Council's in-house team amounted to £185.948 million and all investments complied with the Annual Investment Strategy. This includes monies invested on behalf of the North Eastern Local Enterprise Partnership for whom Sunderland City Council is the accountable body and ANEC which agreed with its member authorities that the council would invest its surplus funds as appropriate and which was reported to members separately at its last meeting. The table below shows the overall return received on these investments compared with the benchmark 7 Day LIBID (London Interbank Bid) rate, which the Council uses to assess its performance.

| | **2013/2014 Actual to 30/11/13 %** | **2013/2014 Benchmark to 30/11/13 %** |
|---|---|---|
| Return on investments | 1.04 | 0.36 |

A3.3 Investments placed in 2013/2014 have been made in accordance with the approved investment strategy and comply with the Counterparty Criteria in place, shown in Appendix B, that 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 and are forecast to remain at low levels until 2016 at the earliest.

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 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) which have an AA+ rating applied to them or in respect of Money Market Funds which are 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 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 | Individual | 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 | **bbb+** | 1 | A3 | - | - | A- | A-2 | 90 | 2 years |
| Lloyds TSB Bank Plc | A | F1 | **bbb+** | 1 | A2 | P-1 | C- | A | A-1 | 90 | 2 years |
| Bank of Scotland Plc | A | F1 | - | 1 | A2 | P-1 | D+ | 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 | Baa1 | P-2 | - | **BBB** | A-2 | 90 | 2 years |
| The Royal Bank of Scotland Plc | A | F1 | bbb | 1 | A3 | P-2 | D+ | **A-** | **A-2** | 90 | 2 years |
| National Westminster Bank Plc | A | F1 | - | 1 | A3 | P-2 | D+ | **A-** | **A-2** | 90 | 2 years |
| Ulster Bank Ltd | A- | F1 | ccc | 1 | Baa2 | P-2 | D- | **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 | Individual | 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- | AA- | 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 | **c** | 5 | Caa1 | NP | E | - | - | 0 | |
| Virgin Money *** | BBB | F3 | bbb | 5 | - | - | - | BBB+ | A-2 | 0 | |
| **Top Building Societies (by asset value)** | | | | | | | | | | | |
| Nationwide BS (see above) | | | | | | | | | | | |
| Yorkshire BS *** | **BBB** | F2 | bbb+ | 5 | Baa2 | P-2 | C- | **-** | **-** | 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 *** | - | - | - | - | 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+ | 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 |
| | | | | | | | | | | | |

| | 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 |
| **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 |
| **Money Market Funds** | | | | | | | | | | 80 | Liquid |
| Prime Rate Stirling Liquidity | 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.