Sunderland City Council

Item No. 7

AUDIT AND GOVERNANCE COMMITTEE **16 December 2016**

TREASURY MANAGEMENT – THIRD QUARTERLY REVIEW 2016/2017

Report of the Interim Director of Corporate Services

1. Purpose of Report

1.1 To report on the Treasury Management (TM) performance to date for the third quarter of 2016/2017.

2. Description of Decision (Recommendations)

2.1 The Committee is requested to:

- Note the positive Treasury Management performance during Quarter 3 of 2016/2017.
- Note the Lending List Criteria at Appendix B and 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 2016/2017, in accordance with the requirements of the Treasury Management Policy and Strategy agreed by Council.

4. Summary of Treasury Management Performance for 2016/2017 – 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. PWLB rates fluctuated throughout 2015/2016 and continue to be volatile. Forecasts suggest the impact of the Brexit vote and low levels of world economic growth will mean that PWLB rates will remain low into the medium term. As PWLB rates were at historically low levels, it was decided to take advantage of these low rates to support the Council's Capital Programme requirements and borrow £20m in Quarter 2. This will help maintain the Council's long-term borrowing interest rate at its comparatively low levels 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 2016/2017 as rates have not been considered sufficiently favourable. It should be noted the Council's interest rate on borrowing is 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 £541.902m for 2016/2017. The Council's maximum external debt during the financial year to 30th November 2016 was £351.771m 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 2016, the funds managed by the Council's Treasury Management team have achieved a rate of return on its investments of 0.83% compared with the benchmark 7 Day LIBID (London Interbank Bid) rate of 0.24%. Performance is significantly above the benchmark rate, whilst still adhering to the prudent policy agreed by the Council, in what remains a very challenging market. The rate of return achieved is also in the top quartile according to our external Treasury Management advisors who have benchmarked our performance with other authorities.

4.6 The rate of return on investments, as previously reported, has remained at the very low levels seen in previous years and is likely to decrease further following the Bank of England cutting the base rate from 0.5% to 0.25% on 4th August 2016. There is little prospect of a significant upturn until the Bank of England begins to increase the Base Rate which may not happen until 2019. Special tranche investment rates (which offer better than market average returns) have also followed the downward trend since base rates were reduced.

Interest rates are continuously monitored so that the Council can take advantage of any increase in rates when they do 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 2016/2017.

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

Appendix A

Detailed Treasury Management Performance – Quarter 3 2016/2017

A1 Borrowing Strategy and Performance – 2016/17

A1.1 The Borrowing Strategy for 2016/2017 was reported to Cabinet on 10th February 2016 and approved by full Council on 2nd March 2016.

The Borrowing Strategy is based upon interest rate forecasts from a wide cross section of City institutions. The view in February 2016, when the Treasury Management Policy and Strategy was drafted, was that the Bank Base Rate would remain at 0.50% until the fourth quarter of 2016 before gradually rising to 1.75% by December 2018. PWLB borrowing rates were also expected to increase during 2016/2017 across all periods.

Following the EU Referendum on 23rd June 2016 and the vote to leave the EU, the Bank of England (BoE) cut the Bank Base Rate for the first time since March 2009 to an all-time low of 0.25%. It also expanded its Quantitative Easing programme by £60bn to £435bn and unveiled two new schemes; one to buy £10bn of high grade corporate bonds and the "Term Funding Scheme" potentially worth up to £100bn offering access to cheap long term funding for those banks that increase their lending activity despite the cut in the base rate. Financial analysts speculate that the Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in June 2019. However, a cut in the Bank Rate has not been dismissed in the unlikely event of a significant fall in economic growth.

The Autumn Statement announced on 23rd November 2016 predicted GDP growth of 2.1% in 2016 compared to 2.0% forecast in the March 2016 Budget due to the momentum created in the run up to the EU Referendum and post-Referendum performance. Growth prospects for future years have been lowered due to the potential of lower output over the next five years, largely as a result of the uncertainties and timing of Brexit. Forecasts for 2017 and 2018 have been revised to 1.4% and 1.7% (down from the March Budget estimates of 2.2% and 2.1% respectively).

Although the UK deficit has fallen over the last six years, debt and borrowing remain high. Given the result of the EU Referendum, the Office for Budgetary Responsibility (OBR) no longer predicts a budget surplus by 2019/20 with the new Chancellor scaling back the timing and pace of deficit elimination to as early as possible in the next Parliament. Public sector net borrowing of £21.9bn is predicted for 2019/20 against a forecast £10.4bn surplus in the March 2016 Budget, highlighting the predicted impact of lower economic growth on tax revenues. Compared to the March 2016 Budget the UK is forecast to need to borrow a further £122bn over the next five years.

The Chancellor also announced the abolition of the Autumn Statement. Instead annual budgets will be held in the Autumn from 2017 and fiscal statements made in the Spring. The new arrangements should support better tax and financial planning with changes announced well ahead of the start of each tax and financial year.

The BoE November Inflation Report revised its inflation forecasts up sharply, largely due to the effect of the sharp fall in the value of sterling since the referendum. The BoE increased the peak forecast for inflation from 2.3% to 2.7% during 2017 with other economic forecasters predicting CPI to peak at 3.2% in 2018. This exceeds the 2.0% target level for inflation and the Monetary Policy Committee has given a clear warning that if wage inflation were to rise significantly they would take action to raise the Bank Rate.

Forecasts for PWLB interest rate levels have risen across all durations since Quarter 2 with benchmark rates of 1.60%, 2.30%, 2.90% and 2.70% for 5, 10, 25 and 50 year durations. Exceptional levels of volatility in PWLB rates and bond yields are expected to continue during 2016 and 2017. The volatility is highly correlated to geo-political events and sovereign debt crisis developments and the likelihood that increases in the US interest rate will occur more quickly and more strongly than the UK Bank Rate.

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

2016/2017	**Qtr 1* (Apr - Jun) %**	**Qtr 2* (Jul - Sep) %**	**Qtr 3* (Oct – Nov) %**
7 days notice	0.36	0.20	0.12
1 year	1.11*	0.88*	0.90*
5 year	1.59*	1.09*	1.37*
10 year	2.25*	1.60*	2.02*
25 year	3.05*	2.34*	2.69*
50 year	2.83*	2.11*	2.46*

*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 2016/2017 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 4.00% for long-term borrowing was set for 2016/2017 in light of the views prevalent at the time the Treasury Management policy was set in March 2016. Volatility in the financial markets in Quarters 1 and 2 saw considerable movement of funds into gilts with a resulting fall in both gilt yields and PWLB rates which the Council has taken advantage of. This position has reversed recently with a large shift away from bonds and into equities and the overall longer term expectation is for gilt yields and PWLB rates to rise, albeit gently.

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 and which will benefit the revenue budget over the longer term. As reported in the Second Quarter Review, the Council has taken out £20 million of new borrowing during the financial year as these rates were considered opportune. The new borrowing is summarised in the following table:

Duration	**Date of the transaction**	**Start**	**Matures**	**Rate %**	**Loan Amount £m**
47½ years	15/06/2016	17/06/2016	17/06/2063	2.55	10.0
46½ years	01/07/2016	05/07/2016	05/01/2063	2.15	10.0

Since taking out this new borrowing rates have fluctuated before recovering to higher rates than the post-Brexit borrowing taken out. The position remains volatile and the Treasury Management team continues to closely monitor PWLB rates to assess the value of possible further new borrowing in line with future Capital Programme requirements.

A1.3 The Borrowing Strategy for 2016/2017 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 2016/2017 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 2017.

A1.4 The Council's treasury portfolio position at 30th November 2016 is set out below:

		Principal (£m)	Total (£m)	Average Rate (%)
Borrowing				
Fixed Rate Funding	PWLB	197.8		
	Market	39.6		
	Other	0.1	237.5	3.68
Variable Rate Funding	Temporary / Other		27.6	0.41
Total Borrowing			**265.1**	**3.34**

A2 Treasury Management Prudential Indicators – 2016/2017

A2.1 All external borrowing and investments undertaken in 2016/2017 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 2016/2017 as follows:

	£m
Borrowing	453.349
Other Long-Term Liabilities	88.553
Total	**541.902**

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

	£m
Borrowing	370.400
Other Long Term Liabilities	88.553
Total	**458.953**

The Council's maximum external debt in respect of 2016/2017 (to 30th November 2016) was £351.771m and is well within the 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		**2016/2017 (to 30/11/16)**	
		Limit £'000	**Actual £'000**
P10	**Upper limit for fixed interest rate exposure**		
	Net principal re fixed rate borrowing / investments	255,000	92,565
P11	**Upper limit for variable rate exposure**		
	Net principal re variable rate borrowing / investments	48,000	-9,830
P12	**Maturity Pattern**	Upper Limit	
	Under 12 months	50%	11.32%
	12 months and within 24 months	60%	1.65%
	24 months and within 5 years	80%	5.77%
	5 years plus	100%	82.68%
	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 – 2016/2017

A3.1 The Investment Strategy for 2016/2017 was approved by Council on 2nd March 2016. 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 2016, the funds managed by the Council's in-house team amounted to £205.560 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.

	2016/2017 Actual to 30/11/16 %	**2016/2017 Benchmark to 30/11/16 %**
Return on investments	0.83	0.24

A3.3 Investments placed in 2016/2017 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 very low levels with further reductions following the decrease in the Bank of England Base Rate from 0.50% to 0.25%.

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) and therefore have the UK Government rating applied to them, or separately 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.

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	120	2 Years
AA+	F1+	A1+	Aa1	P-1	100	2 Years
AA	F1+	A1+	Aa2	P-1	80	2 Years
AA-	F1+ / F1	A1+ / A-1	Aa3	P-1	75	2 Years
A+	F1	A-1	A1	P-1	70	364 days
A	F1 / F2	A-1 / A-2	A2	P-1 / P-2	65	364 days
A-	F1 / F2	A-2	A3	P-1 / P-2	50	364 days
Local Authorities (limit for each local authority)					30	2 years
UK Government (including debt management office, gilts and treasury bills)					350	2 years
Money Market Funds Maximum amount to be invested in Money Market Funds is £120m with a maximum of £50m in any one fund.					120	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.

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 non-UK 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 £100m 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	100

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
Money Market Funds	120
UK Building Societies	100
Foreign Banks	100

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 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	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
UK	AA	-	Aa1	-	AA	-	350	2 years
Lloyds Banking Group (see Note 1)							**Group Limit 80**	
Lloyds Bank Plc	A+	F1	A1	P-1	A	A-1	80	2 years
Bank of Scotland Plc	A+	F1	A1	P-1	A	A-1	80	2 years
Royal Bank of Scotland Group (See Note 1)							Group Limit 80	
Royal Bank of Scotland Group plc	BBB+	F2	Ba1	NP	BBB-	A-3	80	2 years
The Royal Bank of Scotland Plc	BBB+	F2	A3	P-2	BBB+	A-2	80	2 years
National Westminster Bank Plc	BBB+	F2	A3	P-2	BBB+	A-2	80	2 years
Ulster Bank Ltd	BBB+	F2	A3	P-2	BBB	A-2	80	2 years
Santander Group							**Group Limit 65**	
Santander UK plc	A	F1	Aa3	P-1	A	A-1	65	364 days
Barclays Bank plc	A	F1	A2	P-1	A-	A-2	50	364 days
Clydesdale Bank *	BBB+	F2	Baa2	P-2	BBB+	A-2	0	
Co-Operative Bank Plc	B	B	Caa2	NP	-	-	0	
Goldman Sachs International Bank	A	F1	A1	P-1	A	A-1	65	364 days
HSBC Bank plc	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Nationwide BS	A	F1	Aa3	P-1	A	A-1	65	364 days
Standard Chartered Bank	A+	F1	Aa3	P-1	A	A-1	65	364 days
Top Building Societies (by asset value)								
Nationwide BS (see above)								
Coventry BS	A	F1	A2	P-1	-	-	65	364 days
Leeds BS	A-	F1	A2	P-1	-	-	50	364 days
Newcastle BS **	-	-	-	-	-	-	0	
Nottingham BS **	-	-	Baa1	P-2	-	-	0	
Principality BS **	BBB+	F2	Baa3	P-3	-	-	0	
Skipton BS **	A-	F1	Baa2	P-2	-	-	0	
West Bromwich BS **	-	-	B1	NP	-	-	0	
Yorkshire BS **	A-	F1	A3	P-2	-	-	50	364 days

	Fitch		Moody's		Standard & Poor's			
	L Term	S Term	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
Money Market Funds							120	Liquid
Prime Rate Stirling Liquidity	AAA				AAA		50	Liquid
Insight Liquidity Fund	AAA		-		AAA		50	Liquid
Standard Life Investments Liquidity Fund	AAA		-		AAA		50	Liquid
Deutsche Managed Sterling Fund	AAA		Aaa		AAA		50	Liquid
Foreign Banks have a combined total limit of £100m								
Australia	AAA		Aaa		AAA		100	2 years
Australia and New Zealand Banking Group Ltd	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Commonwealth Bank of Australia	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
National Australia Bank	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Westpac Banking Corporation	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Canada	AAA		Aaa		AAA		100	2 years
Bank of Nova Scotia	AA-	F1+	Aa3	P-1	A+	A-1	70	364 days
Royal Bank of Canada	AA	F1+	Aa3	P-1	AA-	A-1+	75	2 years
Toronto Dominion Bank	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Finland	AA+		Aa1		AA+		100	2 years
Nordea Bank Finland plc	AA-	F1+	Aa3	P-1	AA-	A-1+	75	2 years
OP Corporate Bank plc	-	-	Aa3	P-1	AA-	A-1+	75	2 years
Germany	AAA		Aaa		AAA		100	2 years
DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Landwirtschaftliche Rentenbank	AAA	F1+	Aaa	P-1	AAA	A-1+	100	2 years
NRW Bank	AAA	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Netherlands	AAA		Aaa		AAA		100	2 years
Bank Nederlandse Gemeenten	AA+	F1+	Aaa	P-1	AAA	A-1+	100	2 years
Cooperatieve Centrale Raiffeisen Boerenleenbank BA (Rabobank Nederland)	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days

	Fitch		Moody's		Standard & Poor's			
	L Term	S Term	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
Nederlandse Waterschapsbank N.V	-	-	Aaa	P-1	AAA	A-1+	100	2 years
Singapore	AAA		Aaa		AAA		100	2 years
DBS Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Oversea Chinese Banking Corporation Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
United Overseas Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Sweden	AAA		Aaa		AAA		100	2 years
Nordea Bank AB	AA-	F1+	Aa3	P-1	AA-	A-1+	75	2 years
Svenska Handelsbanken AB	AA	F1+	Aa2	P-1	AA-	A-1+	75	2 years
USA	AAA		Aaa		AA+		100	2 years
Bank of New York Mellon	AA	F1+	Aa1	P-1	AA-	A-1+	75	2 years
JP Morgan Chase Bank NA	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days
Wells Fargo Bank NA	AA	F1+	Aa1	P-1	AA-	A-1+	75	2 years

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 £80m.

* 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 Prudential Regulation Authority (PRA) is classed as a UK bank for the purposes of the Approved Lending List.