Agenda Item 7

London Borough of Sutton

Audit Committee –29 April 2011

Report of the Executive Head of Finance

TREASURY MANAGEMENT – QUARTER THREE UPDATE

Ward Location:	Not Applicable	**Author(s) and Contact Phone Number(s):**	
		Lyndsey Gamble Ext 5358	
Area Served:	Borough-Wide	**Lead Councillor:**	
		Councillor John Drage	

Key Decision Report

Summary

This report summarises the Council's Treasury Management operations during the first nine months of 2010/11. It is presented for the purpose of monitoring and review and meets best practice as suggested by the Treasury Management Code of Practice.

No new long term borrowing was undertaken during the period. The Council's original intention was to undertake a first tranche of external borrowing before the end of 2010/11. However this has not been undertaken as balances have not reduced as quickly as expected and options for the preferred borrowing option, market loans, have not been available.

Over the last nine months the Council has continued to invest surplus funds when available and complied with the requirements of the Prudential Code.

The report also highlights changes to the Council's counterparty list following the implementation of the Council's new treasury strategy from 1st April 2011 and how this is impacting on current treasury operations.

Recommendations

The Committee is recommended to:

(i) Note the treasury management activity undertaken during the first nine months of 2010/11

(ii) Note the changes to treasury operation under the new strategy implemented from 1st April 2011

1. Background

1.1 The treasury management function covers the borrowing and investment of Council money. This includes both the management of the Council's day-to-day cash position and the management of its long-term debt. All transactions are conducted in accordance with the Council's Treasury Management Policy Statement which

complies with the latest CIPFA Code of Practice. Good treasury management plays an important part in underpinning the Council's sound financial health.

1.2 This report details investment and borrowing activity over the first nine months of 2010/11. This activity was carried out in line with the treasury strategy for 2010/11 approved by the Council in March 2010.

1.3 In March 2011, the Council approved the new Treasury Management Strategy for operation during 2011/12. This document included a number of revisions to the way in which the Council operates its treasury strategy to improve operations and overcome problems arising during 2010/11. Since this report is being brought to the Committee at the start of 2011/12, it also highlights some of the changes being implemented as part of this new strategy and how that is impacting current treasury operations.

2. Treasury Management Activity April to December 2010

Long Term Borrowing

2.1 With the introduction of the Prudential Code from 1 April 2004, the Council has greater freedom to borrow to support new capital investment. In order to support decisions on prudential borrowing the Council is required to set a number of prudential indicators that confirm that such borrowing is affordable, prudent and sustainable. The Council's treasury management prudential indicators for 2010/11 were approved by the Council on 1 March 2010. Performance against these indicators for quarter 3 is set out in Appendix 1. All activity within the first nine months of the year has been within the limits set by the prudential indicators.

2.2 Under the prudential regime the Council can borrow as required as long as this falls within the 2010/11 prudential limits. The Council's overall external debt at 31st December 2010 totalled £64.8m of which £49.5m was with the Public Works Loan Board (PWLB) and £15.3m was with individual banks. The average annual interest rate of the Council's long term debt remains at 5.01%

2.3 No new long term borrowing was undertaken in the first nine months of the year as the level of internal balances such as reserves and general fund balances was sufficient to enable them to be used rather than resort to external borrowing. However cashflow forecasting suggests that the Council will need to begin to take on external borrowing early in 2011/12 as available internal resources fall and the opportunity for internal borrowing reduces. This is largely due to the Council progressing work on the building of the new Stanley Park High School and using the government grant which has increased the Council's cash balances in recent years.

2.4 Interest rates for borrowing are currently low. Given the Council's need to take on external borrowing during the coming year it is therefore considered advisable to take on a proportion of borrowing now whilst rates remain low to reduce the Council's interest rate risk exposure in the future. Following announcements by Government on the implementation of HRA Reform and the significant level of borrowing that the Council will be required to take on through these arrangements from 1st April 2012, the need to spread interest rate risk is also increased.

2.5 After assessing several options for borrowing, the Council previously placed a bid for a Lender Option Borrower Option (LOBO) loan with the Royal Bank of Scotland for a period of 50 years with three yearly calls. This loan has not progressed and there

are no other private lenders currently in the market so the Council is now considering options for borrowing from the PWLB.

Temporary borrowing

2.6 The Council set a temporary borrowing limit of £16.2m for 2010/11. During the first nine months of the year, there has been no need for the Council to raise any temporary loans. The interest rate for overnight borrowing is currently between 0.45% and 0.6%.

Investments

2.7 During the first nine months of the financial year, the Council has had surplus funds available for investment. The amount fluctuates on a day to day basis although investment balances were still quite high during the first nine months of the year due to the grant received for Stanley Park in advance of expenditure being incurred and the balance held on behalf of the pension fund. As previously explained it is estimated that investment levels will fall during the remaining part of the year as expenditure on the Stanley Park High School project progresses and following the normal pattern of revenue and capital spending occurring towards the latter part of the year. The Council's investment balances including and excluding the Stanley Park grant are shown in Appendix 2.

2.8 The average level of funds available for investment purposes in the first nine months of 2010/11 was £54.2m. These funds were available on a temporary basis and the level of which are largely dependent on the timing of payments, receipt of council tax and grants and progress of the capital programme. Interest earned during that period on these deposits totalled £339k and represented an average interest rate earned by the Council of 1.01%. This compares favourably with the average of the 7 day LIBID (London Interbank Bid Rate) figure of 0.43%. This is used as a suitable benchmark since in the current climate the majority of the Council's core cash is invested for short periods.

2.9 During the third quarter it has still been considered appropriate to keep investments short term therefore the Council has continued to use Money Market Funds (MMFs) and overnight deposits placed directly with UK institutions to minimise risk. This has achieved a reasonable yield on investments commensurate with proper levels of security and liquidity as expressed in the Council's annual investment strategy. Where possible the Council has taken advantage of special tranche rates from nationalised banks such as Lloyds TSB which has increased the overall yield on investments at very little risk to the Council.

3. New Treasury Strategy for 2011/12

3.1 Following the implementation of the Council's revised treasury strategy from 1st April 2011, the Council has the ability to invest with an expanded list of counterparties. The counterparties that the Council can now place investments with is shown in Appendix 3.

3.2 In practice rates currently offered through the range of Money Market Funds (MMFs) and Call accounts that the Council uses are more attractive than the rates offered by these institutions through the financial money markets. This situation may change as

interest rates rise and once proposed changes to Financial Services Authority (FSA) liquidity rules are implemented.

3.3 On 7th April Moody's rating agency announced that it will begin to reassess the implied levels of government support built into long term ratings for UK financial institutions. The agency is beginning the review process in the coming weeks and the initial focus will be on small to medium sized institutions which would likely include most if not all building societies and a number of smaller banks. With regard to larger UK institutions such as Barclays, HSBC, Lloyds, Royal Bank of Scotland and Santander UK, the agency will initially highlight any potential changes through altering rating outlooks but will not formally act on ratings until the second half of 2011.

3.4 At present these changes are unlikely to impact on the Council's treasury operations. This is because the Council is unable to place investments with the majority of UK building societies and smaller banks due to their poor credit ratings and the absence of a Credit Default Swap (CDS) spread for these institutions which Sector's model uses as an early indicator of potential risk. The Council is able to place investments with Nationwide Building Society and will monitor any changes made to their ratings along with any changes made to the outlooks for the smaller and larger UK banks and liaise with Sector where necessary. Any changes made to the outlook of such institutions will reflect Moody's view on the banks ability to cope without financial support from the UK government. However in practice this will also require the implementation of an appropriate exit strategy from the government which is likely to take some time.

4. Outlook for Interest rates

4.1 The bank base rate at the start of the year was 0.50% and it has remained at this level for the first nine months of this year. Sector's current view is that the bank base rate will remain at this level until September 2011 and will then begin increasing to reach 3.25% by December 2013. Public Works Loan Board (PWLB) borrowing rates are expected to rise steadily over the next year for shorter duration loans (up to 5yrs) and remain constant for longer duration loans (10 to 50 yrs). This is Sector's view on what the MPC is likely to do rather than what the MPC ought to do. Their view is that the MPC should hold off from increasing bank rate as long as possible in order to protect economic growth and that current inflation pressures are temporary and will fade.

5. Progression of the Administration of Heritable Bank

5.1 In January the Council received the sixth instalment of the recovery of the £5.5m funds invested with Heritable Bank. The payment represented 4.7 pence in the pound or £261k. A seventh payment was also received on 19th April of a further 6.25 pence in the pound or £346k. These payments bring the total level of funds recovered to £3.122m.

5.2 The projections by administrators for the expected return to unsecured creditors remain at up to 85 pence in the pound as previously reported. This is based on progress to date and the predicted future performance and is still based on cautious assumptions. The potential loss of 15 pence in the pound would amount to £0.8m and has already been provided for from the Councils reserves in the 2008/09 accounts.

5.3 Icelandic courts have recently ruled that local authorities should be given preferred creditor status for repayments of investments made with Landsbanki and Glitnir bank. This decision does not affect the Council since the investments made were with Heritable Bank, a UK subsidiary of Landsbanki.

6. Financial Implications

6.1 Successful treasury management plays an important part in upholding the authority's sound financial position.

7. Influence of the Council's Core Values

7.1 Not applicable.

8. Equality Impact Assessment

8.1 There are no equality issues arising from the matters covered in this report.

9. Background Papers

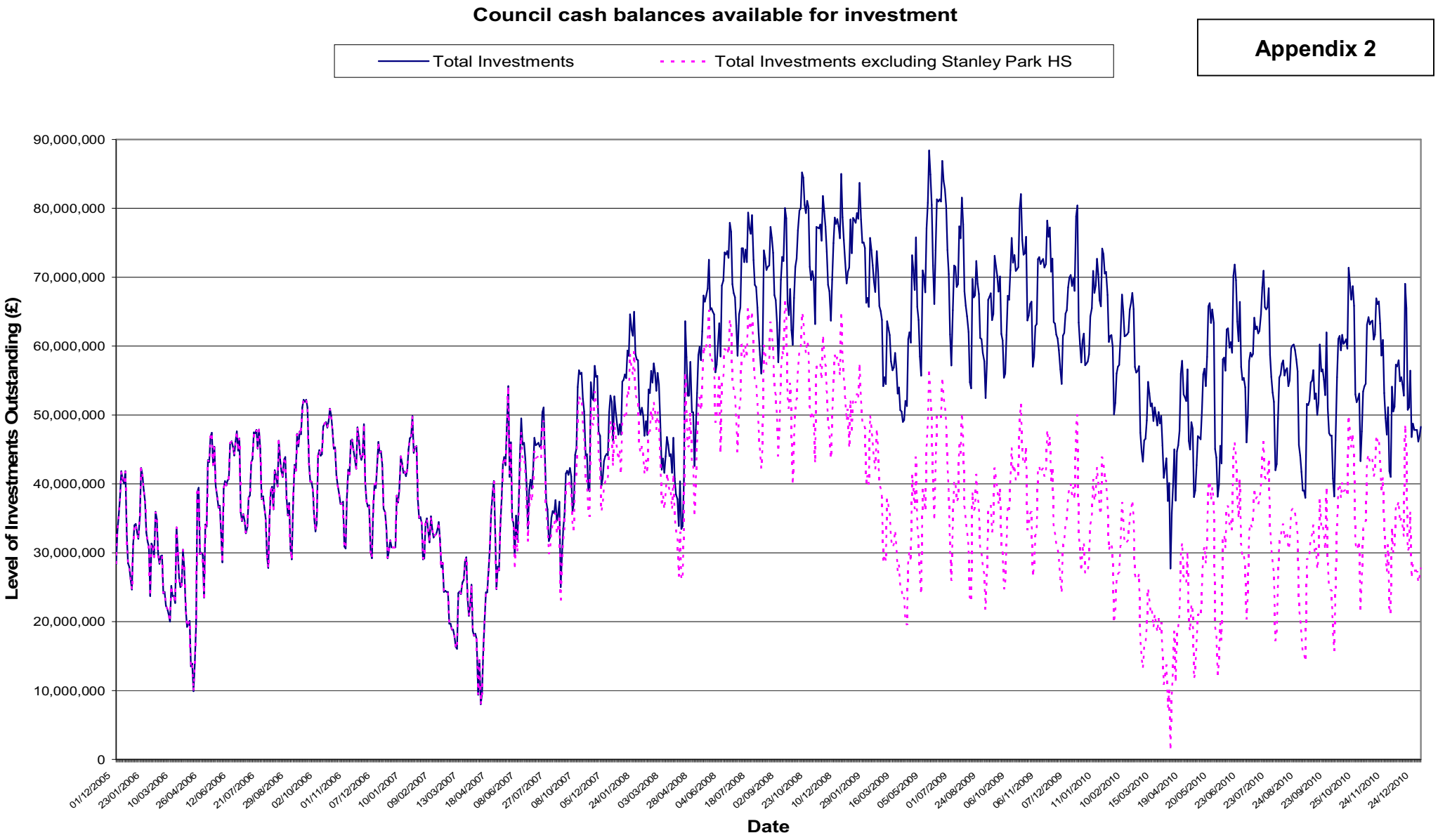
Treasury Management Files

Ernst and Young Progress Report on the Administration of Heritable Bank (Feb 2011)

Appendix 1- Quarter Three Performance against Prudential Indicators

		Original Indicator 2010/11 £000		Actual at 31/12/2010 £000
	PRUDENTIAL INDICATORS			
(1)	Authorised Limit			
	Borrowing	117,100		64,794
	Other Long Term Liabilities	2,300		2,602
		119,400		67,396
(2)	Operational Boundary			
	Borrowing	78,600		64,794
	Other Long Term Liabilities	2,300		2,602
		80,900		67,396
(3)	Interest Rate Exposure			
	Upper limit for fixed rate exposure	119,400		1,195
	Upper limit for variable rate exposure	29,800		15,300
(4)	Upper limit on investments that go over a year	15,000		Nil
(5)	Maturity Structure of Fixed Rate Borrowing	**Upper Limit**	**Lower Limit**	**Actual at 31/12/2010**
	Under 12 months	15%	0%	0.00%
	12 months – 24 months	15%	0%	0.00%
	24 months – 5 years	45%	0%	10.84%
	5 years – 10 years	75%	0%	7.89%
	10 years & above	100%	0%	81.28%
(6)	Adoption of CIPFA Code of Practice	Yes		Yes
	LOCAL INDICATORS			
(7)	Temporary borrowing limit	16,200		16,200
(8)	Maturity Structure –% of total debt maturing in any one year	< 15%		Complied

Appendix 2


Council cash balances available for investment
Total Investments
Total Investments excluding Stanley Park HS
Level of Investments Outstanding (£)
90,000,000
80,000,000
70,000,000
60,000,000
50,000,000
40,000,000
30,000,000
20,000,000
10,000,000
0
01/12/2005
23/01/2006
10/03/2006
26/04/2006
12/06/2006
21/07/2006
29/08/2006
02/10/2006
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06/11/2009
07/12/2009
11/01/2010
10/02/2010
15/03/2010
19/04/2010
20/05/2010
23/06/2010
23/07/2010
24/08/2010
23/09/2010
25/10/2010
24/11/2010
24/12/2010
Date

Appendix 3 –Approved Counterparties

Counterparty	Sector Colour Rating	Maximum Duration	Investment Limit £m
Australia and New Zealand Banking Group Ltd	Orange	12mths	12.5
Commonwealth Bank of Australia	Purple	24 mths	15.0
National Australia Bank Ltd	Orange	12mths	12.5
Westpac Banking Corporation	Purple	24 mths	15.0
Fortis Bank	Green	3 mths	7.5
Danske Bank As	Green	3 mths	7.5
BNP Paribas	Orange	12mths	12.5
CALYON Corporate and Investment Bank	Green	3 mths	7.5
Credit Agricole SA	Orange	12mths	12.5
Societe Generale	Red	6 mths	10.0
Deutsche Bank AG	Red	6 mths	10.0
UniCredit Bank AG	Green	3 mths	7.5
Intesa Sanpaolo	Red	6 mths	10.0
Cooperatieve Centrale Raiffeisen Boerenleenbank BA	Purple	24 mths	15.0
ING Bank NV	Red	6 mths	10.0
DBS Bank Ltd	Orange	12mths	12.5
Oversea Chinese Banking Corporation Ltd	Orange	12mths	12.5
United Overseas Bank Ltd	Orange	12mths	12.5
Banco Santander	Red	6 mths	10.0
Skandinaviska Enskilda Banken AB	Green	3 mths	7.5
Swedbank AB	Green	3 mths	7.5
Svenska Handelsbanken AB	Orange	12mths	12.5
Credit Suisse	Orange	12mths	12.5
UBS AG	Green	3 mths	7.5
Barclays Bank Plc	Red	6 mths	10.0
HSBC Bank plc	Orange	12mths	12.5
Santander UK plc	Green	3 mths	7.5
Standard Chartered Bank	Red	6 mths	10.0
Sumitomo Mitsui Banking Corporation Europe Ltd	Green	3 mths	7.5
JP Morgan Chase Bank NA	Orange	12mths	12.5
Wells Fargo Bank NA	Red	6 mths	10.0

Nationwide BS	Green	3 mths	7.5
Lloyds Banking Group			
Lloyds TSB Bank Plc	Blue	12 mths	15.0
Bank of Scotland Plc	Blue	12 mths	15.0
Royal Bank of Scotland Group plc			
National Westminster Bank Plc	Blue	12 mths	15.0
The Royal Bank of Scotland Plc	Blue	12 mths	15.0
Ulster Bank Ltd	Blue	12 mths	15.0

Notes

1) The table above shows the counterparties that are colour rated by Sector and the Council is able to invest with. The table also shows the maximum investment period and maximum investment limit for each counterparty.

2) A group limit of £15m operates for the Lloyds Banking Group and Royal Bank of Scotland Group.

3) The Council also able to place investments with Money Market Funds (MMFs) that are AAA rated with at least one of the three credit rating agencies.

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