SWANAGE TOWN COUNCIL

Annual Treasury Report 2011/12

Contents

Appendices

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1. Background

The Council's treasury management activity is underpinned by The Chartered Institute of Public Finance and Accountancy's Guidance for Smaller Public Organisations on the Application of the CIPFA Code of Practice for Treasury Management in the Public Services (the "CIPFA TM Code"). The Code recommends that members are informed of treasury management activities at least twice a year. Quarterly reports are issued to the Finance and Performance Management Committee and the scrutiny of treasury policy, strategy and activity is delegated to this Committee.

Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2. Economic Background

At the time of determining the 2011/12 strategy in February 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to bring down the budget deficit and government borrowing and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%. Unemployment was at a 16-year high at 2.5 million and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

Inflation: During 2011-12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushed February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

Growth, Employment, House Prices: Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012 alongside. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the 1 million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

Monetary Policy: It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing (QE) total to £325bn.

The policy measures announced in the March 2012 Budget statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of the independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets; the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

US

The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in economic activity, cast doubts about the permanence of the Fed's policy commitment.

Europe

In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the EFSF bailout fund. The successful Greek sovereign bond swap in March 2012 shortly after its second bailout package allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The ECB's €1.3 trillion Long-Term Refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity and relieved much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

Market sentiment oscillated between 'risk on'/'risk off' modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the 'risk-off' theme which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody's to change the outlook on the UK's triple-A rating from stable to negative. Over the 12-month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates fell commensurately (see Table 2 in Appendix A), but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing remained high, in excess of 4.1 % for 20-year PWLB Maturity borrowing.

Credit

Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign CDS and bond yields were fairly correlated with the countries' banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth and banks' creditworthiness. The European Banking Authority's banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks' Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks' funding and liquidity. These principal factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

3. The Borrowing Requirement and Debt Management

	Balance on 01/04/2011 £	Debt Maturing £	Debt Prematurely Repaid £	New Borrowing £	Balance on 31/03/2012 £
CFR	8,283				0
Long Term Borrowing	(8,283)	8,283	0	0	0
Borrowing Requirement	0				0

The Capital Financing Requirement (CFR) represents the cumulative capital expenditure that has not been financed. The Council made its final payment of £8,283 on its one outstanding loan in July 2011, resulting in a nil CFR.

4. Investment Activity

The CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

Investments	Balance on 01/04/2011 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2012 £
Short Term Investments	5,003,695	9,204,564	8,857,019	5,351,240
Long Term Investments	1,528	100,000	0	101,528
Investments in Pooled Funds	2,000,000	0	0	2,000,000
TOTAL INVESTMENTS	7,005,223			7,452,768
Increase in Investments				447,545

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12. Investments during the year included:

- Deposits with the Debt Management Office
- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies systemically important to the UK's banking system.
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2011/12 treasury strategy was A+/A1 across rating agencies Fitch, S&P and Moody's.

This particular criterion was amended on 23rd January 2012 to A-/A3 in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system. The downgrades were driven principally by the agencies' view of the extent of future government support (flowing from the recommendations to the government from the Independent Commission on Banking) rather than a deterioration in the institutions' creditworthiness.

Counterparty credit quality has been maintained as demonstrated by the Credit Score Analysis summarised below. Table 1 in Appendix B explains the credit score, with the Council aiming to achieve a score of 7 or less.

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2011	3.90	AA-	4.14	AA-	210
30/06/2011	3.90	AA-	4.12	AA-	128
30/09/2011	3.93	AA-	4.14	AA-	45
31/12/2011	3.33	AA	3.43	AA	52
31/03/2012	3.57	AA-	4.74	A+	47

Liquidity

In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits/ the use of call accounts.

Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels (as shown in Table 1 in Appendix A) which had a significant impact on investment income.

The Council's budgeted net investment income for the year had been estimated at £205,800. The average cash balances representing Usable Capital Receipts, Earmarked Reserves and the Council's working balances were £7.3m during the period and interest earned was

£194,783/2.66%. Income earned on a £2m investment with the CCLA LAMIT Property Fund, made in 2010/11, at an average rate of 5.55% provided some cushion against the low interest rate environment.

5. Compliance with the CIPFA Code of Practice

The Council can confirm that it has complied with its Annual Investment Strategy which was approved as part of the Council's Treasury Management Strategy Statement 2011/12 to 2013/14.

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2011/12. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

Appendix A

Table 1: Bank Rate, Money Market Rates

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2011	0.50	0.40	0.54	0.54	0.69	1.12	1.59	1.89	2.36	3.00
30/04/2011	0.50	0.50	0.40	0.49	0.69	1.05	1.52	1.62	2.07	2.74
31/05/2011	0.50	0.40	0.40	0.52	0.69	1.08	1.56	1.53	1.89	2.54
30/06/2011	0.50	0.50	0.40	0.50	0.77	1.06	1.54	1.44	1.82	1.50
31/07/2011	0.50	0.40	0.40	0.50	0.78	1.07	1.55	1.29	1.53	2.09
31/08/2011	0.50	0.40	0.40	0.56	0.86	1.15	1.63	1.27	1.43	1.92
30/09/2011	0.50	0.60	0.60	0.54	0.92	1.21	1.69	1.25	1.38	1.75
31/10/2011	0.50	0.63	0.55	0.56	0.96	1.25	1.74	1.30	1.42	1.81
30/11/2011	0.50	0.65	0.58	0.64	1.01	1.31	1.80	1.41	1.49	1.76
31/12/2011	0.50	0.50	0.65	0.67	1.05	1.35	1.84	1.31	1.34	1.54
31/01/2012	0.50	0.50	0.70	0.68	1.06	1.38	1.87	1.20	1.23	1.46
29/02/2012	0.50	0.50	0.75	0.67	1.05	1.37	1.87	1.22	1.29	1.54
31/03/2012	0.50	0.55	0.55	0.61	1.00	1.33	1.84	1.22	1.30	1.59
Minimum	0.50	0.10	0.35	0.49	0.68	1.01	1.40	1.08	1.23	1.46
Average	**0.50**	0.47	0.52	0.58	0.89	1.21	1.69	1.36	1.55	1.98
Maximum	0.50	0.65	0.95	0.68	1.06	1.38	1.87	1.95	2.42	3.07
Spread	--	0.55	0.60	0.19	0.38	0.37	0.47	0.87	1.19	1.60

Table 2 : PWLB Borrowing Rates - Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2011	128/11	1.93	3.66	4.81	5.33	5.35	5.31	5.28
30/04/2011	162/11	1.73	3.45	4.61	5.18	5.21	5.17	5.14
28/05/2011	202/11	1.64	3.21	4.43	5.08	5.12	5.09	5.07
30/06/2011	246/11	1.61	3.09	4.42	5.17	5.21	5.20	5.18
30/07/2011	288/11	1.52	2.75	4.06	4.97	5.07	5.06	5.04
31/08/2011	332/11	1.48	2.50	3.71	4.66	4.84	4.87	4.85
30/09/2011	376/11	1.51	2.41	3.47	4.35	4.61	4.69	4.69
29/10/2011	418/11	1.45	2.42	3.56	4.29	4.46	4.47	4.44
30/11/2011	462/11	1.32	2.14	3.21	3.84	4.02	4.03	3.98
31/12/2011	501/11	1.21	1.99	3.04	3.86	4.09	4.12	4.08
31/01/2012	042/12	1.29	1.99	3.08	3.89	4.11	4.15	4.12
29/02/2012	084/12	1.31	1.96	3.11	4.04	4.25	4.26	4.21
30/03/2012	128/12	1.28	2.05	3.21	4.17	4.38	4.41	4.36
	Low	1.19	1.93	2.98	3.77	3.98	4.02	3.98
	Average	1.47	2.53	3.70	4.50	4.65	4.67	4.64
	High	1.97	3.73	4.89	5.41	5.42	5.39	5.35

Appendix B

Table 1: Credit Score Analysis

Scoring:

Long-Term Credit Rating	Score
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10
Not rated	11
BB	12
CCC	13
C	14
D	15

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating threshold of A- for investment counterparties.