SWANAGE TOWN COUNCIL

Annual Treasury Report 2015/16

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Annual Treasury Report 2015/16

1. Background

The Council's Treasury Management Strategy for 2015/16 is underpinned by having due regard for the Chartered Institute of Public Finance and Accountancy's (CIPFA) Guidance for Smaller Public Organisations on the Application of the CIPFA Code of Practice on Treasury Management in the Public Services 2009 and the Department for Communities and Local Government (CLG) *Guidance on Local Authority Investments*, issued March 2010. The Code recommends that members are informed of Treasury Management activities at least twice a year (mid-year and at year end).

The Authority's Treasury Management Strategy for 2015/16 was approved by full Council on 19/01/2015 which can be accessed on http://www.swanage.gov.uk/Downloads.aspx.

The Authority has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

2. External Context

Growth, Inflation and Employment: The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from $67 a barrel in May 2015 to just under $28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year/year in February, but this was still well below the Bank of England's 2% inflation target. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

Global influences: The slowdown in the Chinese economy became the largest threat to the South East Asian region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

UK Monetary Policy: The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its Inflation Reports and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

Market reaction: From June 2015 gilt yields were driven lower by a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in a significant volatility in equities and corporate bond yields.

10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

3. Local Context

At 31/03/2016 the Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was nil, while usable reserves which are the underlying resources available for investment were £5.82m. At 31/03/2016, the Authority had no borrowing and £5.49m of investments.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2015/16 capital expenditure plans and treasury strategy did not imply a need to borrow over the 3-year forecast period. Investments are forecast to fall to £4.3m by March 2019, as capital receipts, earmarked reserves and the general fund are used to finance the capital programme.

5. Investment Activity

The Authority has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2015/16 the Authority's investment balances have remained relatively stable at £5.49m throughout the year.

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

Investments	Balance on 01/04/2015 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2016 £
Banks and building societies and other organisations - Short-term (minimum rating A-)	1,292,373	2,014,626	(1,000,149)	2,306,850
AAA-rated Money Market Funds	399,841	1,625	0	401,466
Loans to small businesses / other organisations	10,000		(10,000)	0
Investments in Pooled Funds	2,500,000	0	0	2,500,000
Commercial Paper, Corporate Bonds and other marketable instruments	1,293,569	0	(1,006,834)	286,735
TOTAL INVESTMENTS	**5,495,783**			**5,495,051**
Increase/(Decrease) in Investments				**(732)**

Security of capital remained the Authority's main investment objective. This was maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating is [A-] across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2015	5.33	A+	5.00	A+
30/06/2015	4.73	A+	4.76	A+
30/09/2015	4.8	A+	4.76	A+
31/12/2015	4.92	A+	5.45	A+
31/03/2016	5.36	A+	5.78	A

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Counterparty Update

The transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that the level of loss given default is low.

Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS), Deutsche Bank, Bank Nederlandse Gemeeten and ING. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

Moody's concluded its review in June and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thuringen.

S&P reviewed UK and German banks in June, downgrading the long-term ratings of Barclays, RBS and Deutsche Bank. S&P also revised the outlook of the UK as a whole to negative from stable, citing concerns around the referendum on EU membership and its effect on the economy.

At the end of July 2015, Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September, with the Danish Danske Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

In September, Volkswagen was found to have been cheating emissions tests over several years in many of their diesel vehicles. The council's treasury advisor, Arlingclose Ltd, recommended suspending VW (as a non-financial corporate bond counterparty) for new investments. As issues surrounding the scandal continued, there were credit rating downgrades across the Volkswagen group by all of the ratings agencies. Volkswagen AG is now (as at 11/04/16) rated A3, BBB+ and BBB+ by Moody's, Fitch and S&P respectively. Volkswagen International Finance N.V is rated A3 and BBB+ by Moody's and Fitch respectively and Volkswagen Financial Services N.V. is now rated A1 by Moody's. Arlingclose continues to monitor the situation.

In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

In January 2016, Arlingclose supplemented its existing investment advice with a counterparty list of high quality bond issuers, including recommended cash and duration limits. As part of this, Bank Nederlandse Gemeeten was moved to the list of bond issuers from the unsecured bank lending list and assigned an increased recommended duration limit of 5 years. Interest rates are likely to stay low for longer, making long-term bonds an increasingly attractive option.

The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016, following the publication of many banks' 2015 full-year results, Arlingclose advised the suspension of Deutsche Bank and Standard Chartered Bank from the counterparty list for unsecured investments. Both banks recorded large losses and despite improving capital adequacy this will call 2016 performance into question, especially if market volatility continues. Standard Chartered had seen various rating actions taken against it by the rating agencies and a rising CDS level throughout the year. Arlingclose will continue to monitor both banks.

The end of bank bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities means that the risks of making unsecured deposits continues to be elevated relative to other investment options. The Authority therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits.

During the year the Council has seen relatively little investment activity, with the maturity of a Volkswagen corporate bond being invested in CDs held with Standard Chartered and Nationwide, being the main points to note. The Council also maintained its investments with the Places For People bond (with a maturity date of 26/12/2016). Following the announcement by HM Treasury of the redemption of old stocks at par in March 2015, the Council's Consolidated Stock holdings of £62 were redeemed in July 2015. Swanage Sailing Club also made the final payment of the loan granted in 2011/12. Other investment activity has been the re-investment of interest in the Federated Money Market Fund and the Lloyds call account. Overall the Council's portfolio has reduced by £732 over the year.

The Council retained its investment in the CCLA LAMIT property fund. This fund continues to offer the potential for enhanced returns over the longer term, albeit potentially more volatile in the shorter term. This fund, which is managed by professional fund managers, has allowed the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. They have no defined maturity date, but are available for withdrawal after a notice period.

The funds' performance and continued suitability in meeting the Authority's investment objectives are monitored regularly. The Council received an annualised net return of 5.88% in 2015/16 (4.77% against market value), which provided some cushion against the low interest rates available on its short term, liquid investments. A Property Fund Profile & Fact Sheet at 31st March 2016 is provided in addition to this report.

Budgeted Income and Outturn

The average investment balances were £5.49m during the year. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels (see Table 1 in Appendix 1).

The Council's budgeted investment income for the year was estimated at £149,950. The Authority's actual investment outturn for the year was £181,272.

Externally Managed Funds:

The Authority also has investments in property funds which allow the Authority to diversify into asset classes other than cash with the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the Authority's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.

Although money can be redeemed from the pooled funds at short notice, the Authority's intention is to hold them for the medium-term. Their performance and suitability in meeting the Authority's investment objectives are monitored regularly and discussed with Arlingclose.

6. Compliance

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 2015/16 to 2017/18.

This report provides members with a summary report of the treasury management activity during 2015/16, having due regard to both the CIPFA Code of Practice and the CLG Guidance. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority can confirm that during 2015/16 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

7. Other Items

Investment Training: The needs of the Authority's treasury management staff for training in investment management are assessed as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

During 2015/16 staff attended strategy meetings with Arlingclose.

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
01/04/2015		0.50		0.35	0.46	0.43	0.51	0.76	0.97	0.87	1.05	1.32
30/04/2015		0.50		0.35	0.48	0.43	0.52	0.74	0.98	1.00	1.21	1.51
31/05/2015		0.50		0.43	0.50	0.43	0.52	0.75	0.98	0.97	1.18	1.49
30/06/2015		0.50		0.35	0.45	0.43	0.52	0.79	0.99	1.09	1.35	1.68
31/07/2015		0.50		0.32	0.43	0.43	0.53	0.79	1.01	1.10	1.33	1.66
31/08/2015		0.50		0.42	0.40	0.43	0.54	0.82	1.02	1.03	1.24	1.61
30/09/2015		0.50		0.37	0.41	0.43	0.54	0.74	1.00	0.93	1.11	1.41
31/10/2015		0.50		0.36	0.41	0.43	0.54	0.77	1.00	0.97	1.16	1.49
30/11/2015		0.50		0.30	0.42	0.43	0.54	0.88	1.00	0.93	1.10	1.39
31/12/2015		0.50		0.43	0.35	0.43	0.54	0.76	1.01	1.09	1.30	1.58
31/01/2016		0.50		0.43	0.42	0.43	0.54	0.71	0.99	0.77	0.89	1.14
29/02/2016		0.50		0.25	0.43	0.43	0.54	0.73	0.99	0.71	0.74	0.85
31/03/2016		0.50		0.30	0.44	0.52	0.62	0.71	0.93	0.79	0.84	1.00
Average		**0.50**		**0.38**	**0.45**	**0.43**	**0.54**	**0.76**	**0.99**	**0.96**	**1.14**	**1.43**
Maximum		**0.50**		**0.48**	**0.58**	**0.57**	**0.66**	**0.92**	**1.02**	**1.17**	**1.44**	**1.81**
Minimum		**0.50**		**0.17**	**0.35**	**0.43**	**0.51**	**0.55**	**0.84**	**0.68**	**0.73**	**0.85**
Spread		--		**0.31**	**0.23**	**0.14**	**0.15**	**0.37**	**0.18**	**0.49**	**0.71**	**0.96**