SWANAGE TOWN COUNCIL

Annual Treasury Report 2012/13

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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

The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period. Equity market assets recovered sharply with the FTSE 100 registering a 9.1% increase over the year. This was despite economic growth in G-7 nations being either muted or disappointing.

In the UK the economy shrank in the first, second and fourth quarters of calendar 2012. It was the impressive 0.9% growth in the third quarter, aided by the summer Olympic Games, which allowed growth to register 0.2% over the calendar year 2012. The expected boost to net trade from the fall in the value of sterling did not materialise, but raised the price of imports, especially low margin goods such as food and energy. Avoiding a 'triple-dip' recession became contingent on upbeat services sector surveys translating into sufficient economic activity to overhaul contractions in the struggling manufacturing and construction sectors.

Household financial conditions and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI dipped below 3%, falling to 2.4% in June before ticking up to 2.8% in February 2013. Higher food and energy prices and higher transport costs were some of the principal contributors to inflation remaining above the Bank of England's 2% CPI target.

The lack of growth and the fall in inflation were persuasive enough for the Bank of England to maintain the Bank Rate at 0.5% and also sanction additional £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut was discussed at some of the Bank's Monetary Policy Committee meetings, but was not implemented as the potential drawbacks outweighed the benefits of a reduction in the Bank Rate. In the March Budget the Bank's policy was revised to include the 2% CPI inflation remit alongside the flexibility to commit to intermediate targets.

The resilience of the labour market, with the ILO unemployment rate falling to 7.8%, was the main surprise given the challenging economic backdrop. Many of the gains in employment were through an increase in self-employment and part time working.

The Chancellor largely stuck to his fiscal plans with the austerity drive extending into 2018. In March the Office for Budgetary Responsibility (OBR) halved its forecast growth in 2013 to 0.6% which then resulted in the lowering of the forecast for tax revenues and an increase in the budget deficit. The government is now expected to borrow an additional £146bn and sees gross debt rising above 100% of GDP by 2015-16. The fall in debt as a percentage of GDP, which the coalition had targeted for 2015-16, was pushed two years beyond this horizon. With the national debt metrics out of kilter with a triple-A rating, it was not surprising that the UK's sovereign rating was downgraded by Moody's to Aa1. The AAA status was maintained by Fitch and S&P, albeit with a Rating Watch Negative and with a Negative Outlook respectively.

The government's Funding for Lending Scheme (FLS) initiative commenced in August which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an improvement in the flow of credit to mortgagees, but was still below expectation for SMEs.

The big four banks in the UK – Barclays, RBS, Lloyds and HSBC – and several other global institutions including JP Morgan, Citibank, Rabobank, UBS, Credit Suisse and Deutsche came under investigation in the Libor rigging scandal which led to fines by and settlements with UK and US regulators. Banks' share prices recovered after the initial setback when the news first hit the headlines.

Europe: The Euro region suffered a further period of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. Markets were becalmed after the ECB's declaration that it would do whatever it takes to stabilise the Eurozone and the central bank's announcement in September of its Outright Monetary Transactions (OMT) facility, buying time for the necessary fiscal adjustments required. Neither the Italian elections which resulted in political gridlock nor the poorly-managed bailout of Cyprus which necessitated 'bailing-in' non-guaranteed depositors proved sufficient for a market downturn. Growth was hindered by the rebalancing processes under way in Euroland economies, most of which contracted in Q4 2012.

US: The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. The Federal Reserve shifted policy to focus on the jobless rate with a pledge to keep rates low until unemployment falls below 6.5%. The country's extended fiscal and debt ceiling negotiations remained unresolved.

Gilt Yields and Money Market Rates: Gilt yields ended the year lower than the start in April. By September the 2-year gilt yield had fallen to 0.06%, raising the prospect that short-dated yields could turn negative. 10-year yields fell by nearly 0.5% ending the year at 1.72%. The reduction was less pronounced at the longer end; 30-year yields ended the year at 3.11%, around 25bp lower than in April. Despite the likelihood the DMO would revise up its gilt issuance for 2012/13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; purchases by banks, insurance companies and pension funds driven by capital requirements and the preference for safe harbour government bonds.

One direct consequence of the Funding for Lending Scheme was the sharp drop in rates at which banks borrowed from local government. 3-month, 6-month and 12-month Libid rates which were 1%, 1.33% and 1.84% at the beginning of the financial year fell to 0.44%, 0.51% and 0.75% respectively.

3. The Borrowing Requirement and Debt Management

The Capital Financing Requirement (CFR) represents the cumulative capital expenditure that has not been financed. The Council had a nil CFR at 31st March 2013 and remained debt free throughout the course of the financial year.

4. Investment Activity

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

Investments	Balance on 01/04/2012 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2013 £
Short Term Investments	5,351,240	6,778,715	(6,500,000)	5,629,955
Long Term Investments	101,528	0	(46,667)	54,861
Investments in Pooled Funds	2,000,000	0	0	2,000,000
TOTAL INVESTMENTS	**7,452,768**			**7,684,816**
Increase in Investments				**232,048**

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 2012/13. Investments during the year included:

- Investments in AAA-rated Constant & Variable 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 2012/13 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

In June Moody's downgraded a swathe of banks with global capital market operations, including the UK banks on the Council's lending list - Barclays, HSBC, Royal Bank of Scotland/Natwest, Lloyds TSB Bank/Bank of Scotland, Santander UK plc but none of the ratings fell below the Council's minimum A-/A3 credit rating threshold.

Counterparty credit quality has been maintained as demonstrated by the Credit Score Analysis summarised below. Appendix B explains the credit score.

Credit Score Analysis 2012/13

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)
31/03/2012	3.57	AA-	4.74	A+	47
30/06/2012	3.81	AA-	3.65	AA-	41
30/09/2012	3.71	AA-	4.11	AA-	36
31/12/2012*	5.58	A	5.67	A	50
31/03/2013*	5.63	A	5.66	A	56

**The credit scoring for the Money Market Funds (MMFs) in the investment portfolio has changed in the last two quarters. Previously these received the lowest credit risk score of 1, based upon their AAA wrapper ratings. To better reflect the underlying credit risk of each MMF, they are now scored based upon the credit ratings of the top ten holdings (by percentage of fund size) of each Fund. This has resulted in a higher average risk score for all MMFs and has therefore affected the overall scoring compared to the previous three quarters.*

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 and 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 £155,000 The average cash balances representing Usable Capital Receipts, Earmarked Reserves and the Council's working balances were £7.7m during the period and interest earned was £166,667 or 2.16%.

Externally Managed Funds

The Council holds a £2m investment with the CCLA Local Authorities Property Fund. The Council received an annualised net return of 5.47% in 2012/13, 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 2013 is provided in addition to this report.

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 2012/13 to 2014/15.

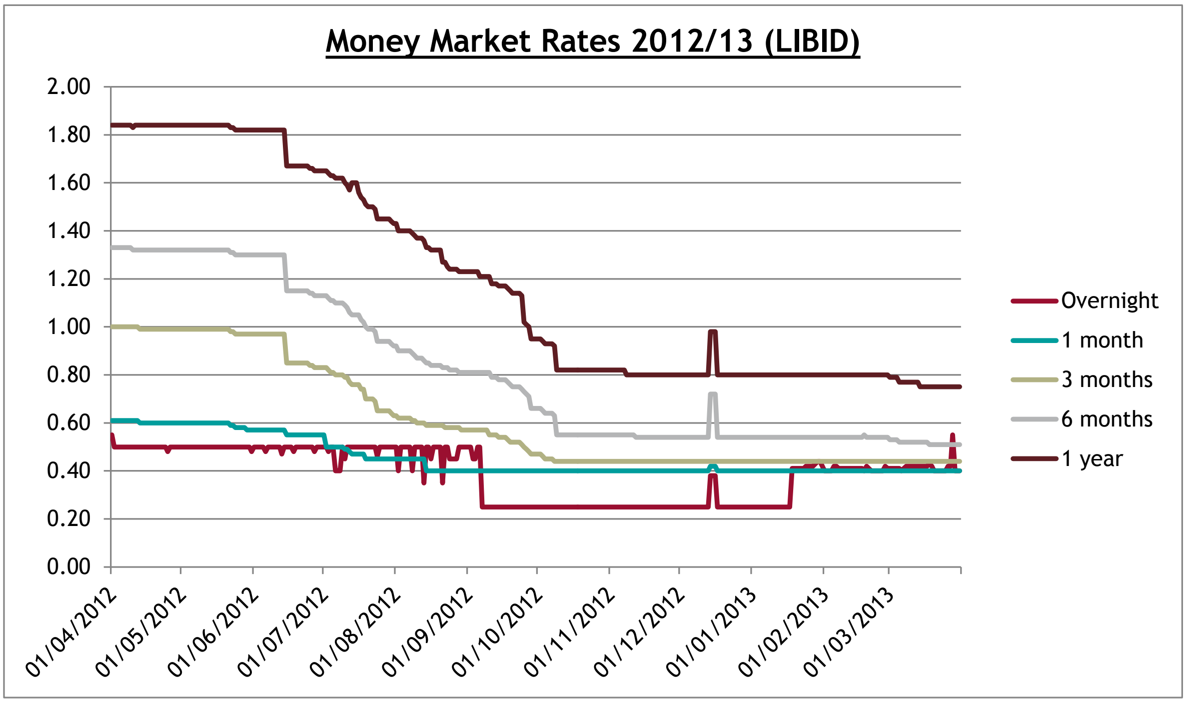
In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2012/13. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority can confirm that during 2012/13 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

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
01/04/2012		0.50		0.55	0.55	0.61	1.00	1.33	1.84	1.24	1.30	1.59
30/04/2012		0.50		0.50	0.65	0.60	0.99	1.32	1.84	1.35	1.43	1.68
31/05/2012		0.50		0.48	0.65	0.57	0.97	1.30	1.82	1.20	1.20	1.34
30/06/2012		0.50		0.50	0.50	0.55	0.83	1.13	1.65	0.96	0.99	1.25
31/07/2012		0.50		0.50	0.65	0.45	0.63	0.92	1.43	0.76	0.77	1.02
31/08/2012		0.50		0.50	0.52	0.40	0.57	0.81	1.23	0.75	0.78	1.01
30/09/2012		0.50		0.25	0.52	0.40	0.47	0.66	0.95	0.70	0.76	1.00
31/10/2012		0.50		0.25	0.44	0.40	0.44	0.55	0.82	0.69	0.77	1.05
30/11/2012		0.50		0.25	0.30	0.40	0.44	0.54	0.80	0.73	0.80	1.05
31/12/2012		0.50		0.25	0.43	0.40	0.44	0.54	0.80	0.69	0.76	1.00
31/01/2013		0.50		0.42	0.43	0.40	0.44	0.54	0.80	0.73	0.86	1.17
29/02/2013		0.50		0.41	0.42	0.40	0.44	0.54	0.80	0.59	0.69	1.05
31/03/2013		0.50		0.40	0.40	0.40	0.44	0.51	0.75	0.59	0.68	0.97
Minimum		0.50		0.25	0.30	0.40	0.44	0.51	0.75	0.55	0.65	0.90
Average		**0.50**		0.39	0.49	0.45	0.62	0.82	1.19	0.84	0.90	1.17
Maximum		0.50		0.55	0.65	0.61	1.00	1.33	1.84	1.38	1.45	1.72
Spread		--										



Appendix B

Credit Score Analysis

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 of threshold of A- for investment counterparties.