SWANAGE TOWN COUNCIL

Annual Treasury Report 2013/14

Contents

Appendices

Page left intentionally blank

Annual Treasury Report 2013/14

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. External Content

Economic background: At the beginning of the 2013-14 financial year markets were concerned about lacklustre growth in the Eurozone, the UK and Japan. Lack of growth in the UK economy, the threat of a 'triple-dip' alongside falling real wages (i.e. after inflation) and the paucity of business investment were a concern for the Bank of England's Monetary Policy Committee. Only two major economies – the US and Germany – had growth above pre financial crisis levels, albeit these were still below trend. The Eurozone had navigated through a turbulent period for its disparate sovereigns and the likelihood of a near-term disorderly collapse had significantly diminished. The US government had just managed to avoid the fiscal cliff and a technical default in early 2013, only for the problem to re-emerge later in the year.

With new Governor Mark Carney at the helm, the Bank of England unveiled forward guidance in August pledging to not consider raising interest rates until the ILO unemployment rate fell below the 7% threshold. In the Bank's initial forecast, this level was only expected to be reached in 2016. Although the Bank stressed that this level was a ***threshold*** for consideration of rate increase rather than an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose aggressively.

The recovery in the UK surprised with strong economic activity and growth. Q4 2014 GDP showed year-on-year growth of 2.7%. Much of the improvement was down to the dominant service sector, and an increase in household consumption buoyed by the pick-up in housing transactions which were driven by higher consumer confidence, greater availability of credit and strengthening house prices which were partly boosted by government initiatives such as Help-to-Buy. However, business investment had yet to recover convincingly and the recovery was not accompanied by meaningful productivity growth. Worries of a housing bubble were tempered by evidence that net mortgage lending was up by only around 1% annually.

CPI fell from 2.8% in March 2013 to 1.7% in February 2014, the lowest rate since October 2009, helped largely by the easing commodity prices and discounting by retailers, reducing the pressure on the Bank to raise rates. Although the fall in unemployment (down from 7.8% in March 2013 to 7.2% in January 2014) was faster than the Bank of England or indeed many analysts had forecast, it hid a stubbornly high level of underemployment. Importantly, average earnings growth remained muted and real wage growth (i.e. after inflation) was negative. In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

The Office of Budget Responsibility's 2.7% forecast for economic growth in 2014 forecast a quicker fall in public borrowing over the next few years. However, the Chancellor resisted the temptation to spend some of the proceeds of higher economic growth. In his 2013 Autumn Statement and the 2014 Budget, apart from the rise in the personal tax allowance and pension changes, there were no significant giveaways and the coalition's austerity measures remained on track.

The Federal Reserve's then Chairman Ben Bernanke's announcement in May that the Fed's quantitative easing (QE) programme may be 'tapered' caught markets by surprise. Investors began to factor in not just an end to QE but also rapid rises in interest rates. 'Tapering' (a slowing in the rate of QE) began in December 2013. By March 2014, asset purchases had been cut from \$75bn to \$55bn per month with expectation that QE would end by October 2014. This had particular implications for global markets which had hitherto benefited from, and got very accustomed to, the high levels of global liquidity afforded by QE. The impact went further than a rise in the dollar and higher US treasury bond yields. Gilt yields also rose as a consequence and emerging markets, which had previously benefited as investors searched for yield through riskier asset, suffered large capital outflows in December and January.

With the Eurozone struggling to show sustainable growth, the European Central Bank cut main policy interest rates by 0.25% to 0.25% and the deposit rate to zero. Markets were disappointed by the lack of action by the ECB despite CPI inflation below 1% and a looming threat of deflation. Data pointed to an economic slowdown in China which, alongside a weakening property market and a highly leveraged shadow banking sector, could prove challenging for its authorities.

Russia's annexation of the Ukraine in March heightened geopolitical tensions and risk. The response from the West which began with sanctions against Russia which is the second largest gas producer in the world and which supplies nearly 30% of European natural gas needs and is also a significant supplier of crude oil – any major disruption to their supply would have serious ramifications for energy prices.

Gilt Yields and Money Market Rates: Gilt yields ended the year higher than the start in April. The peak in yields was during autumn 2013. The biggest increase was in 5-year gilt yields which increased by nearly 1.3% from 0.70% to 1.97%. 10-year gilt yields rose by nearly 1% ending the year at 2.73%. The increase was less pronounced for longer dated gilts; 20-year yields rose from 2.74% to 3.37% and 50-year yields rose from 3.23% to 3.44%.

3-month, 6-month and 12-month Libid rates remained at levels below 1% through the year.

3. The Borrowing Requirement and Debt Management

The Authority is debt free. The 2013/14 capital expenditure plans and treasury strategy did not imply a need to borrow over the 3-year forecast period as capital receipts, earmarked reserves and the general fund were used to finance the capital programme.

4. Investment Activity

The CLG's Investment Guidance requires the Authority to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield.

Investments	Balance on 01/04/2013 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2014 £
Banks and building societies and other organisations - Short-term	4,473,975	1,797,541	(3,600,000)	2,671,516
AAA-rated Money Market Funds	1,155,980	1,936	(500,000)	657,916
Loans to small businesses / other organisations	53,333	0	(26,666)	26,667
Investments in Pooled Funds	2,000,000	500,000	0	2,500,000
Commercial Paper, Corporate Bonds and other marketable instruments	1,528	1,320,731	0	1,322,259
TOTAL INVESTMENTS	**7,684,816**			**7,178,358**
Increase/(Decrease) in Investments				**(506,458)**

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 2013/14 which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

New investments with banks were primarily the use of the Lloyds call account, as the Council moved away from term deposits. In addition, the Council invested £1.8m with organisations and pooled funds without credit ratings following external assessment and advice from the Authority's treasury management adviser, Arlingclose.

Credit developments and credit risk management

The Authority assessed and monitored counterparty credit quality 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 and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2013/14 treasury strategy was A- across rating agencies Fitch, S&P and Moody's.

The debt crisis in Cyprus was resolved by its government enforcing a 'haircut' on unsecured investments and bank deposits over €100,000. This resolution mechanism, in stark contrast to the bail-outs during the 2008/2009 financial crisis, sent shockwaves through Europe but allowed banking regulators to progress reform which would in future force losses on investors through a ‘bail-in’ before taxpayers were asked to support failing banks.

The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution’s shareholders, bondholders and unsecured investors.

Proposals were also announced for EU regulatory reforms to Money Market Funds which may result in these funds moving to a VNAV (variable net asset value) basis and losing their ‘triple-A’ credit rating wrapper in the future.

The material changes to UK banks’ creditworthiness were (a) the strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%, (b) the announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS’ long-running restructuring, further delaying the bank’s return to profitability) and (c) substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

In July Moody’s placed the A3 long-term ratings of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Authority reduced its duration to overnight for new investments with the bank(s). In March Moody’s downgraded the long-term ratings of both banks to Baa1. As this rating is below the Authority’s minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment.

The Co-op’s long-term ratings were downgraded by Moody’s and Fitch to Caa1 and B respectively, both sub-investment grade ratings. The Co-op Bank’s capital raising plans to plug a capital shortfall include a contribution from the Co-op Group which is committed to injecting £313m in 2014 of which £50m has been paid so far. However, in order to cover future expected losses and to meet the Prudential Regulation Authority’s capital targets, a further £400m is being sought from shareholders, of which Co-operative Group’s share is approximately £120m. Given the Co-op Group’s own financial position, payment of these sums is by no means certain, leaving the bank with a precarious capital position.

The Authority’s counterparty credit quality has been maintained as demonstrated by the Credit Score Analysis summarised below. The table in Appendix B explains the credit score.

Credit Score Analysis 2013/14

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)
31/03/2013	5.63	A	5.66	A	56
30/06/2013	5.75	A	5.65	A	44
30/09/2013	5.83	A	5.97	A	25
31/12/2013	5.83	A	5.91	A	8
31/03/2014	6.05	A	6.05	A	100

Liquidity Management

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

Yield

The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels (as shown in table 1 in Appendix A) which continued to have a significant impact on investment income. The average 3-month LIBID rate during 2013/14 was 0.45%, the 6-month LIBID rate averaged 0.53% and the 1-year LIBID rate averaged 0.78%. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

The Authority estimated it would have substantial cash balances over the medium term and it therefore continued the use of pooled funds: the CCLA Local Authorities Property Fund. This fund offers the potential for enhanced returns over the longer term, but may be more volatile in the shorter term. The Council increased its units held during the course of the year from £2m to £2.5m. 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 4.75% in 2013/14, 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 2014 is provided in addition to this report.

The Authority's budgeted investment income for the year had been estimated at £155,000. The average cash balances representing the Authority's reserves, working balances, were £7.4m during the period and interest earned was £172,200.

5. 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 2013/14 to 2015/16.

This report provides members with a summary report of the treasury management activity during 2013/14, 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 2013/14 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

6. 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 2013/14 staff attended training courses and seminars provided by Arlingclose and King & Shaxson.

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
01/04/2013		0.50		0.40	0.50	0.40	0.44	0.51	0.75	0.59	0.68	0.97
30/04/2013		0.50		0.50	0.47	0.40	0.44	0.51	0.75	0.57	0.64	0.91
31/05/2013		0.50		0.38	0.42	0.40	0.44	0.51	0.75	0.68	0.82	1.15
30/06/2013		0.50		0.43	0.38	0.40	0.44	0.51	0.75	0.78	0.99	1.52
31/07/2013		0.50		0.42	0.50	0.40	0.44	0.51	0.75	0.68	0.86	1.39
31/08/2013		0.50		0.43	0.41	0.41	0.44	0.51	0.76	0.81	1.10	1.71
30/09/2013		0.50		0.38	0.38	0.41	0.44	0.51	0.76	0.83	1.12	1.73
31/10/2013		0.50		0.38	0.38	0.42	0.45	0.53	0.80	0.79	1.07	1.66
30/11/2013		0.50		0.38	0.36	0.42	0.45	0.54	0.81	0.80	1.11	1.76
31/12/2013		0.50		0.35	0.35	0.42	0.45	0.54	0.81	1.00	1.43	2.13
31/01/2014		0.50		0.36	0.41	0.42	0.45	0.55	0.82	0.94	1.34	1.95
28/02/2014		0.50		0.36	0.40	0.42	0.45	0.60	0.83	0.98	1.34	1.95
31/03/2014		0.50		0.35	0.39	0.42	0.46	0.56	0.84	1.05	1.45	2.03
Minimum		0.50		0.30	0.35	0.40	0.44	0.51	0.75	0.55	0.62	0.87
Average		**0.50**		0.40	0.41	0.41	0.45	0.53	0.78	0.81	1.08	1.63
Maximum		0.50		0.50	0.50	0.45	0.53	0.65	0.84	1.05	1.47	2.17
Spread		--		0.20	0.15	0.05	0.09	0.14	0.09	0.5	0.85	1.29

Appendix B

Table 2: 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

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.