SWANAGE TOWN COUNCIL

Annual Treasury Report 2014/15

Contents

Appendices

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Annual Treasury Report 2014/15

1. Background

The Council's Treasury Management Strategy for 2014/15 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 2014/15 was approved by full Council on 20/01/2014 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 and Inflation: The robust pace of GDP growth of 3% in 2014 was underpinned by a buoyant services sector, supplemented by positive contributions from the production and construction sectors. Resurgent house prices, improved consumer confidence and healthy retail sales added to the positive outlook for the UK economy given the important role of the consumer in economic activity.

Annual CPI inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in the oil price (which fell to $44.35 a barrel a level not seen since March 2009) and a steep drop in wholesale energy prices with extra downward momentum coming from supermarket competition resulting in lower food prices. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but rebound around the end of 2015 as the lower prices dropped out of the annual rate calculation.

Labour Market: The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. January 2015 showed a headline employment rate of 73.3%, while the rate of unemployment fell to 5.7% from 7.2% a year earlier. Comparing the three months to January 2015 with a year earlier, employee pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

UK Monetary Policy: The Bank of England's MPC maintained interest rates at 0.5% and asset purchases (QE) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to get panicked into response to the current low rate of inflation. The minutes of the MPC meetings reiterated the

Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Bank Rate would be gradual and limited, and below average historical levels.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum. The risk of upheaval (the pledge to devolve extensive new powers to the Scottish parliament; English MPs in turn demanding separate laws for England) lingers on. The highly politicised March Budget heralded the start of a closely contested general election campaign and markets braced for yet another hung parliament.

On the continent, the European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05% in September and the rate paid on commercial bank balances held with it was from -0.10% to -0.20%. The much-anticipated quantitative easing, which will expand the ECB's balance sheet by €1.1 trillion was finally announced by the central bank at its January meeting in an effort to steer the euro area away from deflation and invigorate its moribund economies. The size was at the high end of market expectations and it will involve buying €60bn of sovereign bonds, asset-backed securities and covered bonds a month commencing March 2015 through to September 2016. The possibility of a Greek exit from the Eurozone refused to subside given the clear frustrations that remained between its new government and its creditors.

The US economy rebounded strongly in 2014, employment growth was robust and there were early signs of wage pressures building, albeit from a low level. The Federal Reserve made no change to US policy rates. The central bank however continued with 'tapering', i.e. a reduction in asset purchases by $10 billion per month, and ended them altogether in October 2014. With the US economy resilient enough to weather the weakness of key trading partners and a strong US dollar, in March 2015 the Fed removed the word "patient" from its statement accompanying its rates decisions, effectively leaving the door open for a rise in rates later in the year.

Market reaction: From July, gilt yields were driven lower by a combination of factors: geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big slide in the price of oil and its transmission through into lower prices globally. 5-, 10- and 20-year gilt yields fell to their lows in January (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

3. Local Context

At 31/03/2015 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 £5.44m.

At 31/03/2015, the Authority had no borrowing and £5.49m of investments. The Authority's current strategy is to remain debt free subject to holding a minimum investment balance of £4m.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2014/15 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 £4.6m by March 2018, 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 2014/15 the Authority's investment balances have ranged from £7.18m to £5.49m.

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 01/04/2014 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2015 £
Banks and building societies and other organisations - Short-term (minimum rating A-)	2,671,516	20,857	(1,400,000)	1,292,373
AAA-rated Money Market Funds	657,916	1,925	(260,000)	399,814
Loans to small businesses / other organisations	26,667	0	(16,667)	10,000
Investments in Pooled Funds	2,500,000	0	0	2,500,000
Commercial Paper, Corporate Bonds and other marketable instruments	1,322,259	1,002,078	(1,030,768)	1,293,569
TOTAL INVESTMENTS	**7,178,358**			**5,495,783**
Increase/(Decrease) in Investments				**(1,682,575)**

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 2014/15.

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
31/03/2014	6.05	A	6.05	A
30/06/2014	5.86	A	6.02	A
30/09/2014	5.81	A	5.23	A+
31/12/2014	5.92	A	6.09	A
31/03/2015	5.33	A+	5.00	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

Counterpart Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014-15 Moody's revised the Outlook of several UK and EU banks from Stable to Negative (note, this is not the same as a rating review negative) and S&P placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries' early adoption of the bail-in regime in the BRRD.

S&P also revised the Outlook for major Canadian banks to negative following the government's announcement of a potential bail-in policy framework.

The Bank of England published its approach to bank resolution which gave an indication of how the reduction of a failing bank's liabilities might work in practice. The Bank of England will act if, in its opinion, a bank is failing, or is likely to fail, and there is not likely to be a successful private sector solution such as a takeover or share issue; a bank does not need to be technically insolvent (with liabilities exceeding assets) before regulatory intervention such as a bail-in takes place.

The combined effect of the BRRD and the UK's Deposit Guarantee Scheme Directive (DGSD) is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

In December the Bank's Prudential Regulation Authority (PRA) stress tested eight UK financial institutions to assess their resilience to a very severe housing market shock and to a sharp rise in interest rates and address the risks to the UK's financial stability. Institutions which 'passed' the tests but would be at risk in the event of a 'severe economic downturn' were Lloyds Banking Group and Royal Bank of Scotland. Lloyds Banking Group, [whose constituent banks are on the Authority's lending list], is taking measures to augment capital and the PRA does not require the group to submit a revised capital plan. RBS, which is not on the Authority's lending list for investments, has updated plans to issue additional Tier 1 capital. The Co-operative Bank failed the test.

The European Central Bank also published the results of the Asset Quality Review (AQR) and stress tests, based on December 2013 data. 25 European banks failed the test, falling short of the required threshold capital by approximately €25bn (£20bn) in total – none of the failed banks featured on the Authority's lending list.

In October following sharp movements in market signals driven by deteriorating global growth prospects, especially in the Eurozone, Arlingclose advised a reduction in investment duration limits for unsecured bank and building society investments to counter the risk of another full-blown Eurozone crisis. Durations for new unsecured investments with banks and building societies which were previously reduced. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

The outlawing of 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 rose relative to other investment options. The Authority therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds 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 Vodafone Bond and the re-investment in a Volkswagen corporate bond being the point of note. The Council also maintained its investments with the Places For People bond (with a maturity date of 26/12/2016). HM Treasury announced the redemption of old stocks at par and in March 2015, the Council's War Stock holdings of £1,466 were also redeemed. 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 £1.68m over the year. This significant reduction in short term monies held by the Council (from Lloyds call account and the Federated and Ignis MMFs) is attributable to the financing of the Council's capital programme.

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 5.6% in 2014/15 (4.86% 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 2015 is provided in addition to this report.

Budgeted Income and Outturn

The average cash balances were £6.3m 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 £149,000. The Authority's actual investment outturn for the year was £182,237.

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 2014/15 to 2016/17.

This report provides members with a summary report of the treasury management activity during 2014/15, 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 2014/15 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 2014/15 staff attended training courses and seminars provided by 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
01/04/2014		0.50		0.36	0.39	0.42	0.46	0.56	0.84	1.05	1.44	2.03
30/04/2014		0.50		0.36	0.40	0.42	0.47	0.57	0.85	1.09	1.47	2.02
31/05/2014		0.50		0.35	0.40	0.43	0.48	0.67	0.87	1.11	1.46	1.98
30/06/2014		0.50		0.36	0.40	0.43	0.50	0.71	0.94	1.33	1.70	2.17
31/07/2014		0.50		0.37	0.41	0.43	0.50	0.72	0.97	1.34	1.71	2.17
31/08/2014		0.50		0.36	0.42	0.43	0.50	0.77	0.98	1.22	1.53	1.93
30/09/2014		0.50		0.43	0.45	0.43	0.51	0.66	1.00	1.25	1.57	1.99
31/10/2014		0.50		0.40	0.43	0.43	0.51	0.66	0.98	1.10	1.38	1.78
30/11/2014		0.50		0.35	0.50	0.43	0.51	0.66	0.97	0.93	1.15	1.48
31/12/2014		0.50		0.43	0.48	0.42	0.51	0.66	0.97	0.92	1.12	1.44
31/01/2015		0.50		0.45	0.45	0.43	0.51	0.66	0.95	0.83	0.98	1.18
28/02/2015		0.50		0.43	0.47	0.43	0.51	0.66	0.96	0.99	1.22	1.53
31/03/2015		0.50		0.50	0.62	0.43	0.51	0.74	0.97	0.88	1.06	1.34
Average		**0.50**		**0.39**	**0.44**	**0.43**	**0.50**	**0.67**	**0.95**	**1.09**	**1.38**	**1.79**
Maximum		**0.50**		**0.50**	**0.62**	**0.43**	**0.51**	**0.81**	**1.00**	**1.38**	**1.77**	**2.26**
Minimum		**0.50**		**0.24**	**0.36**	**0.42**	**0.46**	**0.56**	**0.84**	**0.80**	**0.96**	**1.18**
Spread		**--**		**0.26**	**0.26**	**0.01**	**0.05**	**0.25**	**0.16**	**0.58**	**0.81**	**1.08**