Appendix 2

Treasury Management (TM) Update Report

1 Changes in the external environment

1.1 Economic Outlook

The UK economy has shown continued signs of improvements over the course of 2013, with growth for the first three quarters totalling 2.1% and CPI inflation falling to the target level of 2%. The growth in the economy can largely be attributed to an increase in consumer confidence due to a rise in UK house prices and a falling unemployment rate. Despite strong growth, risks remain that this consumer led recovery will not take hold, as weak trading updates from high street retailers cast doubt on expectations of an economic boost from a strong Christmas season while industrial production / construction data suggested growth in these two sectors stalled in November.

The economic recovery is at a delicate stage so we will continue to be cautious in relation to our current investment strategy and this is likely to continue for the medium term until we see stronger signs of sustained economic growth.

2 Investment Strategy

2.1 Our current investment time limits with the banks which we invest with have remained the same since the last update as follows:

- Royal Bank of Scotland (RBS) and National Westminster Bank for a maximum period of **overnight**,
- Close Brothers for a maximum period of **100 days**,
- Lloyds TSB and Bank of Scotland for a maximum period of **6 months**;
- Nationwide BS and Barclays for a maximum period of **12 months**.

2.2 The Council has also been investing with the UK Government's Debt Management Office which is currently paying a rate of 0.25% and this option has been used when safe limits have been reached with financial institutions.

2.3 There are some changes proposed in the investment strategy for 2014/15 to diversify our investments across a larger number of financial institutions which will reduce our current reliance on a limited number of UK banks. This action is being taken because of a lower likelihood that the UK and other governments will support failing banks in the future. As the Banking Reform Act 2014 is implemented, banks will no longer be able to rely on bail-outs and they will be expected to stand on their own feet. This increases the risk to large investors such as local authorities who may be required to provide a proportion of the amount required to cover the bank's losses in the event of default. This new risk has been termed 'bail-in' risk and is potentially a greater risk to investors than the 'bail-out' risk of the past.

2.4 These changes include a reduction in our banking group limit which is currently set at 1.5 times the individual bank limit for a group of banks under the same ownership. For example, we currently set our limit with the Lloyds banking group at £12m and our individual bank limit is £8m so we have £8m invested with Lloyds Bank and £4m with Bank of Scotland which is within the Lloyds banking group. The proposal in the new strategy is for the group limit to be set at the same level as the individual bank limit which would mean a reduction in our group limit from £12m to £8m. In our example above, we would have to reduce the amount invested with Lloyds Bank from £8m to £4m and we would also need to reduce the cash we have invested with the RBS banking group by £4m.

2.5 The impact of this is that this cash will need to be invested elsewhere and we have the following options for dealing with this:

- Other local authorities
- Building Societies (as discussed below)
- Money Market Funds

2.6 As a result of an improvement in the housing market and a strengthening of building societies' balance sheets, the 2014/15 strategy will add a number of building societies to our investment list which will help us to spread our investments over a larger number of financial institutions. This will include building societies without credit ratings where an external credit assessment by our treasury advisers, Arlingclose Ltd, shows them to be suitably creditworthy.

3 Borrowing Strategy

3.1 Borrowing strategies continue to be influenced by the relationship between investment and borrowing rates. Borrowing rates are considerably higher than investment rates at the moment and this difference creates a "cost of carry" for any new longer term borrowing where the proceeds are temporarily held as investments.

3.2 In view of this, the strategy which has been in place for some time now has been to reduce our investment balances and rely on internal borrowing as much as possible instead of external borrowing from the Public Works Loan Board (PWLB). This has been sustainable because the level of the Council's balances and reserves has been sufficient to avoid the need for external borrowing.

3.3 However, as the Corporate Plan is now progressing, we intend to review this strategy and begin to undertake new borrowing. Borrowing rates are also expected to rise so the intention is to borrow to take advantage of the lower rates which are available currently. Although this will create a cost of carry while the proceeds are temporarily held as investments, we will save in the long term because of the anticipated increase in borrowing rates which will result in higher interest costs if we delay.

4 Controls

4.1 Prudential Indicators

The Council sets prudential indicators which set boundaries within which our treasury management activity operates. The indicators are calculated to demonstrate that the Council's borrowing is affordable and include measures that show the impact of capital and borrowing decisions over the medium term. The Council has remained within all of its borrowing and investment limits for 2013/14 agreed by Council in February 2013. The Council has not deviated from the Capital related indicators either.

4.2 Audit Reviews

Following a positive internal audit review in February 2013 which was reported on in the last update report, the next audit review will be undertaken in February 2014 and the recommendations will be reported in the next update.

5 Future

5.1 TM Strategy for next six months

As the Corporate Plan is now progressing, we intend to undertake new borrowing to take advantage of the lower rates which are available currently before the anticipated rise in rates. The Council will monitor market conditions and interest rate levels to ensure that external borrowing is undertaken at the optimal time.

5.2 Reports

The next reports will be the annual TM Report 2013/14 and the TM Update Report 2014/15 which will be reported to the Corporate Governance Committee in September.