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 2014. 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.

1.2 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 changed slightly since the last update as follows:

- Royal Bank of Scotland (RBS) and National Westminster Bank suspended,
- Close Brothers and Leeds Building Society for a maximum period of **100 days**,
- Nationwide BS, Barclays Bank, Santander UK, Lloyds Bank and Bank of Scotland for a maximum period of **13 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 Since the last update, we have diversified our investments across a larger number of financial institutions to reduce our reliance on a limited number of UK banks. This action has been 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 Consequently, we have reduced our banking group limit from 1.5 times the individual bank limit for a group of banks under the same ownership to the same level as the individual bank limit. For example, our limit with the Lloyds banking group was £12m previously and our individual bank limit is £8m. This meant that we had to reduce the amount invested with the Lloyds banking group from £12m to £8m.

2.5 In March 2014, Moody's downgraded the long-term ratings of RBS and Natwest Banks to Baa1. As this rating is below the Authority's minimum credit criterion of A-, RBS was withdrawn from the counterparty list for further investment. The Council had £12m invested with the RBS banking group at that time. Natwest is the Council's banker and will continue to be used for operational and liquidity purposes up to a maximum limit of £1m.

2.6 The impact of this was that the cash had to be invested elsewhere and the following counterparties were added to accommodate this:

- Santander UK
- Nationwide Building Society (see note below)
- Leeds Building Society (see note below)

As a result of an improvement in the housing market and a strengthening of building societies' balance sheets, the 2014/15 strategy added a number of building societies to our investment list which has helped us to spread our investments over a larger number of financial institutions. This includes 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 Following the loans we undertook earlier in the year, it was anticipated that rates would increase. The rates have remained low however and we took advantage of this in August by taking out a new loan for £10m at a rate of 3.5% over a 23.5 year period on an Equal Instalment of Principal (EIP) basis.

3.2 This action was taken as the Corporate Plan is now progressing so we will be using our reserves. Borrowing rates are expected to rise at some point so we will continue to monitor interest rates throughout the year to ensure that we undertake further borrowing if required at the most advantageous time.

3.3 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. For example, a 1% increase in the rates would cost us approximately £1.2m more in interest based on the example above of a £10m loan over a 23.5 year period.

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 2014/15 agreed by Council in February 2014. The Council has not deviated from the Capital related indicators either.

4.2 Audit Reviews

The Internal Audit review undertaken in February 2014 concluded that key risks within the TM function continue to be well managed. The report listed the following key areas which are managed well:

- There is regular reporting to elected members on the Council's treasury management activities, and the Corporate Governance Committee approved the annual Treasury Management Strategy Statement in January 2014.
- Sufficient business continuity arrangements are in place to provide cover within the treasury management function in the absence of the Technical Accountant. A clear separation of duties also exists within the process.
- The contract with the Council's external treasury management advisors, Arlingclose ended in December 2013. An appropriate tendering exercise for contract renewal was carried out with the involvement of the Strategic Procurement Unit. A new contract has been awarded to Arlingclose based on value for money and the quality of service provided.
- Treasury management processes and procedures are robust, well established and our testing of a sample of investments and cash flow statements identified that procedures are followed meticulously. Key risks are effectively managed, with only a few low risk areas for improvement identified, which have been discussed with the Technical Accountant.
- While there has been no recent loans taken out, the Council will need to borrow to fund the Corporate Plan.

5 Future

5.1 TM Strategy for next six months

As the Corporate Plan is progressing, we will review our cash position throughout the year to ensure that we undertake further borrowing if required. The Council will also monitor market conditions and interest rate levels to ensure that external borrowing is undertaken at the optimal time in line with our TM strategy.

5.2 Housing Revenue Account Subsidy Reform

The Welsh Government is in negotiations with HM Treasury regarding the reform of the HRA subsidy system in Wales. Details of the precise mechanism & timing are not available at this stage. The authority will monitor developments in this area as further details become available. It is likely the changes will be implemented from 2015/16 but we will need to borrow approximately £39m to buy ourselves out of the subsidy scheme before the end of 2014/15.

5.3 Private Finance Initiative (PFI)

The Council has a PFI scheme which is shown on the Balance Sheet at a value of £10m. We are currently reviewing the TM implications of the scheme and a separate paper is included on the agenda which provides further details of this review.

5.4 Reports

The next reports will be the Treasury Management Strategy Statement and Prudential Indicators 2015/16 and the TM Update Report 2014/15 which will be reported to the Corporate Governance Committee in January.