Report No: 146/2020
PUBLIC REPORT

CABINET

17th November 2020

MID YEAR REPORT ON TREASURY MANAGEMENT AND PRUDENTIAL INDICATORS 2020/21

Report of the Strategic Director for Resources

<table>
<tr><td>Strategic Aim:</td><td colspan="3">Customer-focussed services</td></tr>
<tr><td colspan="2">Key Decision: No</td><td colspan="2">Forward Plan Reference: FP/091020</td></tr>
<tr><td colspan="2">Exempt Information</td><td colspan="2">No</td></tr>
<tr><td colspan="2">Cabinet Member(s) Responsible:</td><td colspan="2">Mr G Brown, Deputy Leader and Portfolio Holder for Planning and Finance</td></tr>
<tr><td>Contact Officer(s):</td><td>Saverio Della Rocca, Strategic Director for Resources (s.151 Officer)</td><td colspan="2">01572 758159
sdrocca@rutland.gov.uk</td></tr>
<tr><td></td><td>Andrew Merry, Finance Manager</td><td colspan="2">01572 758152
amerry@rutland.gov.uk</td></tr>
<tr><td>Ward Councillors</td><td colspan="3">Not Applicable</td></tr>
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DECISION RECOMMENDATIONS
That Cabinet: 1. Notes the contents of the report and Appendices A to C.

1 PURPOSE OF THE REPORT

1.1 This report updates Members with the progress against the Treasury Management Strategy, prudential indicators and highlights whether any policies require revision.

1.2 The underlying purpose of this report supports the objective in the CIPFA Code of Practice on Treasury Management (revised 2017) and the Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance which requires that Members receive reports on and adequately scrutinise the treasury management service.

2 BACKGROUND AND MAIN CONSIDERATIONS

2.1 The Council's mid-year treasury report is included in Appendix A and includes information on the performance of the treasury management service. The key points to note for the six months to 30 September 2020 are:

- The Council has invested with institutions as determined by the creditworthiness criteria approved by the Section 151 Officer. Since investments were made, there has been a change to the credit rating of one institution where the Council invested £1m. We are regularly monitoring the situation, however the risk of any loss is deemed to be minimal;

- The Council explained that it had invested with the Skipton Building Society in error (details were given in Report 99/2020). The Council reported that the risk of non repayment was low and we can now confirm that a full repayment has been made.

- The Council has made a return on investment of 0.59% compared to the LIBOR rate of 0.09%. The Council is underperforming on its investment income budget by c£53k due to the reduction in the Base Rate to 0.10% as a reaction to the Coronavirus pandemic. The returns achieved are still positive in light of challenging economic conditions;

- The Council has not undertaken any external borrowing in the six months to 30 September 2020. The Council is still below its authorised limit for borrowing of £33m;

- No external debt was repaid early as there was not a financial business case to do so. The total premium (i.e. the charge for repaying early) for the Council's debt portfolio was £24.36m as at 30th September 2020;

- No Commercial Investments were made in the first 6 months as no suitable opportunities for investment arose; and

- The Council received the final receipts of £17k in respect of Heritable bank. RCC's total claim was for £1,014,015.34 (£1million principal and £14,015.34 interest), in total the Council have received £1,011,446.52 (99.75%).

3 CONSULTATION

3.1 No formal consultation is required.

4 ALTERNATIVE OPTIONS

4.1 The report is for noting, there are no alternative options.

5 FINANCIAL IMPLICATIONS

5.1 There are no financial implications arising from this report.

6 LEGAL AND GOVERNANCE CONSIDERATIONS

6.1 The report meets the requirements of both the CIPFA Code of Practice on Treasury Management, the CIPFA Prudential Code for Capital Finance in Local Authorities and the Council's Financial Procedure Rules. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

6.2 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;

- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken;

- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;

- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;

- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;

- Under the Act the CLG has issued Investment Guidance to structure and regulate the Council's investment activities; and

- Under Section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices.

6.3 The Council's Treasury Management Strategy explains how it complies with this legal framework.

7 DATA PROTECTION IMPLICATIONS

7.1 A data protection impact assessment has not been completed as there are no data protection implications.

8 EQUALITY IMPACT ASSESSMENT

8.1 An Equality Impact Assessment (EqIA) has not been completed because the report does not represent the introduction of a new policy or service or a change / to an existing policy or service that has an impact on any particular group.

9 COMMUNITY SAFETY IMPLICATIONS

9.1 There are no community safety implications.

10 HEALTH AND WELLBEING IMPLICATIONS

10.1 There are no health and wellbeing implications.

11 CONCLUSION AND SUMMARY OF REASONS FOR THE RECOMMENDATIONS

11.1 The report summarises treasury management performance in the year to date and meets the requirements set out in Section 6.

12 BACKGROUND PAPERS

12.1 Statement of Accounts 2019/20

12.2 Quarter 1 Finance Management Report

12.3 Quarter 2 Finance Management Report

13 APPENDICES

13.1 Appendix A - Treasury Management Mid-Year Report

13.2 Appendix B - Link Commentary on the six months to 30 September 2020

13.3 Appendix C - Glossary

A Large Print or Braille Version of this Report is available upon request – Contact 01572 722577.

APPENDIX A - Treasury Management Mid-Year Report

1 INTRODUCTION

1.1 Background to Treasury Management

1.1.1 The Council is required to operate a balanced budget, which means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed to meet day-to-day running costs and planned capital expenditure. Any surplus monies are invested in counterparties or instruments commensurate with the Council's risk appetite, providing adequate liquidity initially before considering investment return.

1.1.2 The second main function of the treasury management service is the funding of the Council's capital plans as set out in the Budget and Capital Investment Strategy (CIS). These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.1.3 CIPFA defines treasury management 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."

1.2 What framework or rules do we need to follow?

1.2.1 As local authorities have seen a significant drop in local government funding, there has been increased investments in assets – often outside the local authority area – in a bid to generate revenue and balance the books.

1.2.2 Some of the deals that local authorities have entered into, often funded by significant borrowing, have raised concerns with the property deals being much bigger than core Council business such that a crash in property markets could effectively render some Council's 'bankrupt'.

1.2.3 On the back of this activity, updated guidance was produced:

- Prudential Code for Capital Finance in Local Authorities (2011) (Prudential Code) - this has been updated and introduces a formal requirement for a capital strategy to be approved by Council including "the authority's approach to investments and commercial activities including processes, due diligence and defining the authorities risk appetite in respect of these including proportionality in respect of overall resources".

- Treasury Management: Code of Practice and Cross-Sectoral Guidance Notes (Treasury Management Code) - this has been updated and again requires more explicit reference to how non treasury investments are managed – "It is critical that due diligence processes and procedures reflect the additional risk an organisation is taking on. Due diligence procedures should ensure effective scrutiny of proposed investments, identification of risk to both capital and returns, any external underwriting of those risks, and the potential impact on the financial sustainability of the organisation if those risks come to pass".

- Minimum Revenue Provision - Guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003. This prevents various practices such as spreading the MRP charge over a period longer than 50 years or making retrospective changes which give rise to a credit – "Changing the method used to calculate MRP can never give rise to an overpayment, and should not result in a LA making a charge of £nil for the accounting period in which the change is made".

- Guidance on Local Authority investments - Issued under section 15(1)(a) of the Local Government Act 2003. This guidance is consistent with the Codes described above.

1.2.4 The Council approved a Strategy in February 2020 (report 05/2020) which covered:

- The Capital Prudential Indications
- Borrowing Strategy
- Annual Investment Strategy and Commercial Investment Policy
- The Treasury Prudential Indicators and MRP Statement

1.2.5 The TMS allows for treasury investment in property funds, corporate bonds alongside short term deposits. The Council developed a Commercial Investment Policy that allows for capital investments in property etc that yield a positive net return for the Revenue Account to help subsidise the provision of other Council services, this was included as part of the Capital Investment Strategy.

2 THE CAPITAL PRUDENTIAL INDICATORS 2020/21

2.1 Capital Expenditure

2.1.1 The Council's capital expenditure plans as set out in the budget are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1.2 The capital expenditure prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. As at 30 September 2020 the Council estimates that it will have capital projects approved of £28.695m. The details of this are shown in Quarter 2 Financial Management Report (Report No: 141/2020)

2.1.3 The Council's forecast capital expenditure for 2020/21 is £8.97m. The Quarter 2 report (141/2020) contains detailed analysis of the revised capital programme and financing. The £8.97m was financed as per the table below. The financing need represents an increase in borrowing requirements.

	2020/21 Treasury Strategy Estimate*	2020/21 Original Estimate **	2020/21 Revised Estimate
	£000	**£000**	**£000**
Total Projects	449	3,570	8,767
Total Commercial Activities/ non-financial investments	10,000	10,000	204
Total ring fenced grants-unallocated	2,467	0	0
Capital Expenditure	**12,916**	**13,570**	**8,971**
Financed by:			
Capital Receipts	0	153	242
Capital Grants & Contributions	2,717	2,686	7,998
Revenue	0	44	44
Total Financing	**2,717**	**2,883**	**8,284**
Net financing need for the year	**10,200**	**10,687**	**687**
Net financing need relating to commercial investments	10,000	10,000	0
Percentage of total net financing need	98%	94%	0%

* The Treasury Management Strategy report was presented to Cabinet on 21 January 2020, before the Capital Programme was approved.
** The 2019/20 Outturn Report 84/2020 updated the Capital Programme with 2020/21 carry forwards and additional capital schemes.

2.2 The Council's Borrowing Need (the Capital Financing Requirement)

2.2.1 The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

2.2.2 The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

2.2.3 The Council's CFR forecast for 2020/21 is shown below; both the overall CFR and with the commercial activities CFR separately identified and represents a key prudential indicator.

	2019/20 Actual	2020/21 Treasury Strategy Estimate	2020/21 Revised Estimate
	£000	**£000**	**£000**
CFR – 1 April	**21,245**	**21,267**	**20,631**
Movement in Year -			
Net financing need for the year (from table at para 2.1.3)	0	10,200	687
MRP	(614)	(697)	(614)
Total Movement in Year	(614)	9,503	73
CFR – 31 March	**20,631**	**30,770**	**20,704**

	2019/20 Actual	2020/21 Treasury Strategy Estimate	2020/21 Revised Estimate
	£000	**£000**	**£000**
CFR Commercial Activities – 1 April	**0**	**0**	**0**
Movement in Year -			
Net financing need for the year	0	10,000	0
MRP	0	0	0
Total Movement in Year	0	10,000	0
CFR Commercial Activities – 31 March	**0**	**10,000**	**0**

3 BORROWING

3.1 Borrowing objectives

3.1.1 Councils borrow to fund capital expenditure or refinance/reschedule existing borrowing e.g. replace one loan with one at a lower rate. There are 7 types of borrowing outlined in the strategy.

3.1.2 Effectively, the Council works out its capital expenditure plans and then calculates how much it needs to borrow having considered whether it should fund capital expenditure using other options. The Council's objectives are to:

- avoid external borrowing as far as possible (i.e. use other sources of funding first where possible) unless that borrowing yields income or deliver savings beyond the cost of borrowing;

- repay borrowing early if this is financially prudent and viable;
- reduce its borrowing charge if this represents value for money;
- ensure any new borrowing is affordable; and
- work within prudential indicator limits.

3.2 Current borrowing portfolio

3.2.1 The Council currently has loans outstanding of £22.436m of which £21.386m are long term loans with the Public Works Loans Board (PWLB). PWLB is managed as part of the UK Debt Management Office, which is a HM Treasury Executive Agency. The remainder is a £630k Local Enterprise Partnership interest free loan which matures in 2023, and an interest free Salix loan of £420k repayable in 2020. Included within the £21.386m is £8.232m of debt that was inherited from Leicestershire in the Local Government Re-organisation in 1997.

3.2.2 No additional borrowing has been undertaken so far in 2020/21. The last time the Council actually borrowed from the PWLB was in 2008 to contribute towards funding the Oakham bypass, the value of this loan was £4m.

3.2.3 All PWLB loans have been borrowed on a maturity basis. Interest payments will be made every six months on equal instalments throughout the term of the loan, with the principal being re-paid on the maturity date.

3.2.4 The table below shows the actual external debt against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing. A key prudential indicator is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR.

	2019/20 Actual £000	2020/21 TMS Estimate £000	2020/21 Revised Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000
Gross Debt	22,226	27,142	22,142	27,058	26,386
Capital Financing Requirement (CFR)	20,631	30,770	20,703	30,062	29,220
Under / (Over) borrowing	(1,595)	3,628	(1,439)	3,004	2,834

*Under Borrowing Position explained in Treasury Management Strategy 2020/21 (5/2020)

3.2.5 Within the above figures the level of debt and the CFR relating to commercial activities / non-financial investment is

Commercial Activities	2019/20 Actual £000	2020/21 TMS Estimate £000	2020/21 Revised Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000

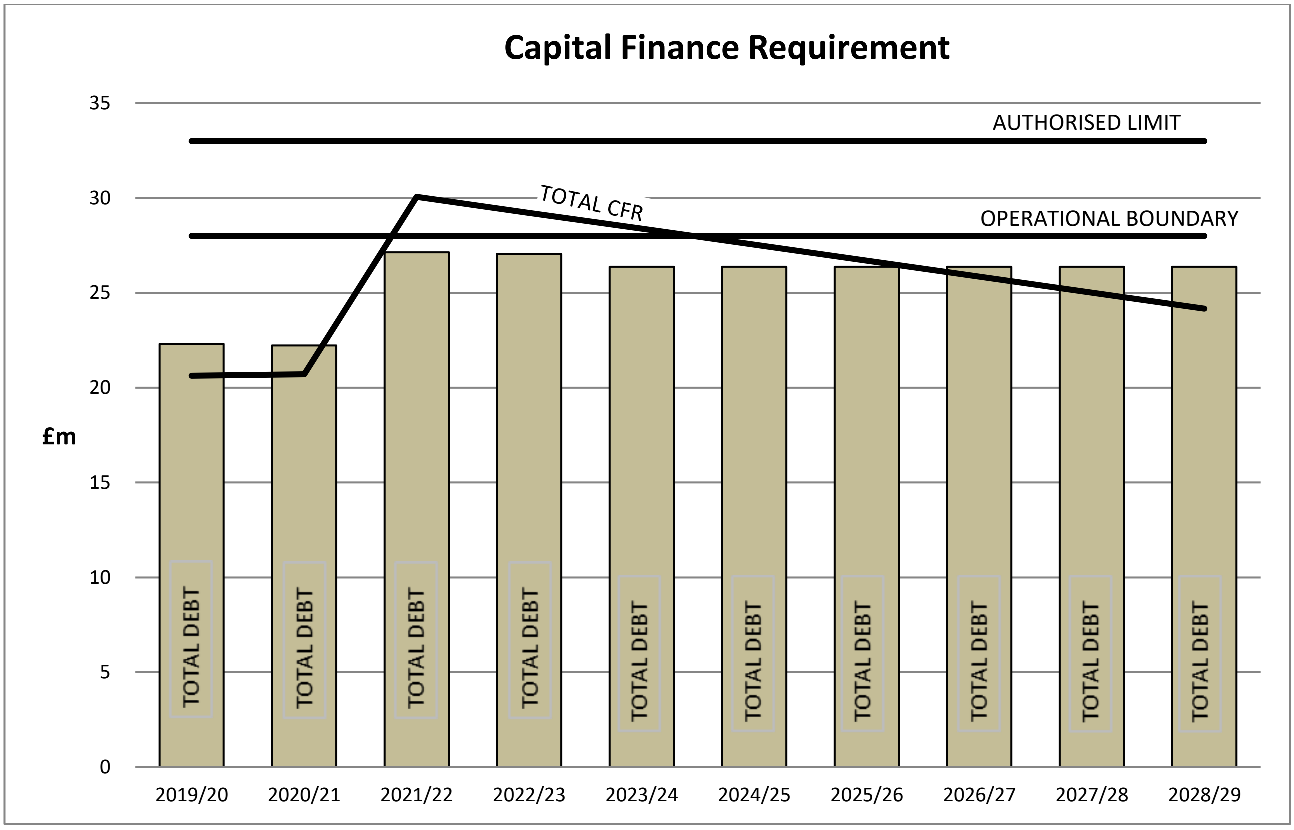
Gross Debt	0	5,000	0	5,000	5,000
Capital Financing Requirement (CFR)	0	10,000	0	10,000	9,992
Under / (Over) borrowing	0	5,000	0	5,000	4,992

3.3 Treasury Indicators: Limits to Borrowing Activity

3.3.1 ***The operational boundary*** **-** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

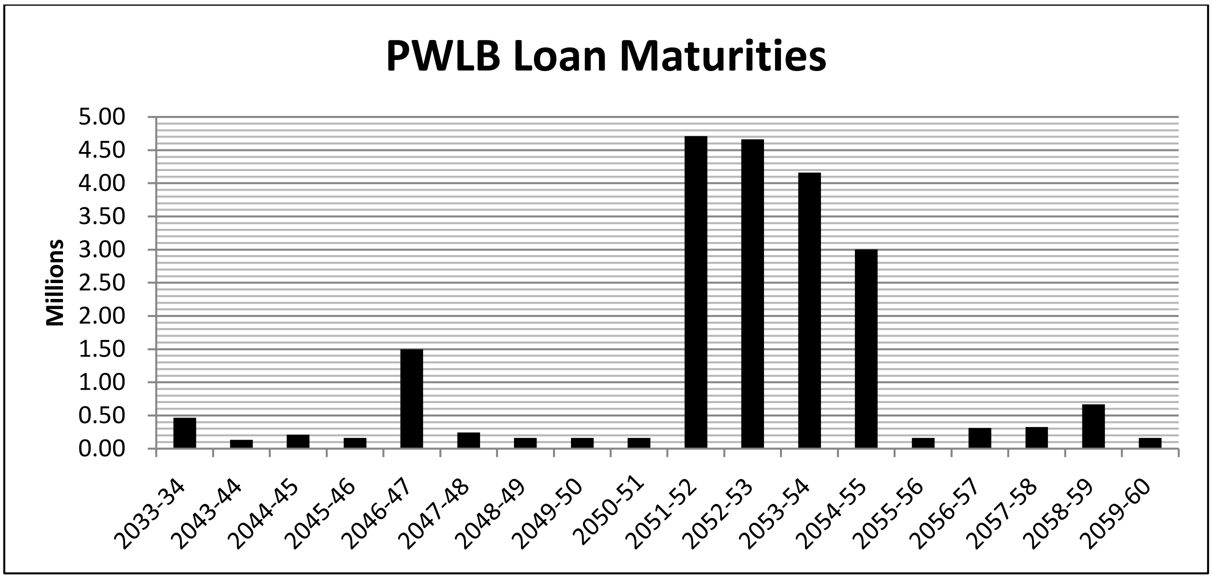
3.3.2 ***The authorised limit for external debt***. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

3.3.3 The graph below shows where we currently are against all of the borrowing prudential indicators.



3.4 Debt Repayment and rescheduling

3.4.1 The table below demonstrates when PWLB debt is due to be repaid.



3.4.2 The latest advice from Link, the Council's Treasury Management Advisors, indicates that the premium at 30 September 2020 was £24.36m. This would mean it would cost £24.36m in addition to the £21.386m principal to repay the Council's PWLB loans.

4 INVESTMENT STRATEGY REVIEW

4.1 Investment overview

4.1.1 The Council receives substantial income from council tax, business rates and central government. The majority of council tax and business rates payments are received between April and January, with expenditure being fairly static throughout the year.

4.1.2 During the first half year investments have ranged from £38.5m to £52.2m. The table below shows the level of investments held at 30 September 2020 and the forecasted balances to the end of the Financial Year.

	Investments 31-Mar-20 £000	**Investments 30-Sep-20** £000	**Forecast Investments 31-Mar-21** £000
UK Banks *(f)*	20,554	18,766	13,462
UK Building Societies *(f)*	3,000	4,000	3,000
UK Local Authorities	14,000	21,500	20,500
Total Fixed Interest Rates *(f)*	**37,554**	**44,266**	**36,962**
Total Variable Interest Rates *(v)*	**0**	**0**	**0**
Total Investments	**37,554**	**44,266**	**36,962**

4.1.3 Most of the Councils investments are made at fixed interest rates over 6 -12 months. For cash flow purposes, some funds are held in instant access accounts.

4.1.4 The revised budget position for investment income is:

	Original Estimate 2020/21 £000	**Received to 30-Sep-20** £000	**Revised Estimate 2020/21** £000
Investment Income	288	147	218
Other Interest Received *	12	22	29
Total	300	169	247

***** The Council also receives interest from sources other than investments. A Housing Association has been recharged £12k for the principal and interest of loans that the Council has made to it, the final payment will be in 2051/52. A final dividend from Heritable Bank of £17k has been received in 2020/21.

4.2 Investment rules

4.2.1 Like us as individuals, the Council will invest surplus money in various ways to get a return on balances thus generating extra income. As per our overall objectives, we ensure that these surplus balances are managed in a way to maximise the income potential whilst having regard to security risk.

4.2.2 The Council's investment strategy primary objectives, in order of importance are:

- safeguarding the re-payment of the principal and interest of its investments on time – losing any funds like in the case of Icelandic banks would be very significant in this financial climate;
- ensuring adequate liquidity – the Council does not want to run short of money so it cannot pay its bills or does not have money available to make investments in capital expenditure;
- maximising the investment return – this is clearly important but the Council does not want to maximise returns at the expense of the first two objectives.

4.2.3 Investments totalling £3 million were made with Skipton Building Society during 2019/10 outside the minimum credit criteria as previously reported in the Mid Year report on Treasury Management 2019/20 (report number 168/2019) and Annual Report on Treasury Management (report number 92/2020). This occurred due to an error on the Council's credit counterparty list provided by Link Asset Services. These investments have now been fully repaid.

4.2.4 An investment of £1m with Close Brothers was rolled over for 364 days to 13th April 2021 as Close Brothers met the minimum credit criteria. Fitch credit rating agency downgraded their short-term rating from F1 to F2 which falls outside the minimum credit criteria after the deal was agreed to roll over. The ratings from Moody's credit rating agency have not changed and still meet the minimum set. No other funds are currently invested with Close Brothers.

4.2.5 For each deal undertaken a risk of default percentage is calculated, using defaults of similar rated organisations. The risk of default for Close Brothers is currently 0.028%. The overall risk of default on the whole investment portfolio is 0.012% which is well below the 0.1% maximum allowable percentage.

4.2.6 There are no concerns around Close Brothers in the media, and the Council are keeping under the review any further movement on this position. Close Brothers have now been removed from the investment list.

4.3 Investment Performance

4.3.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. An example of a performance indicator often used for the investment treasury function is internal returns above the 6 month LIBOR rate (the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another). The Council monitored performance against the LIBOR rate for the first six months of 2020/21 and the results are shown on the following page.

	2019/20	**2020/21 (Q1)**	**2020/21 (Q2) (Cumulative)**
RCC Returns (%)	0.95	0.77	0.59
LIBOR (%)	0.73	0.29	0.09

4.3.2 The Council is underperforming budget by c£53k due to the Base Rate of 0.10% affecting the low interest rates offered by banks and building societies and is the main reason returns have fallen.

4.3.3 In addition to the investment return from short term investments the Council has also received a £17k dividend from the administrators of the Heritable bank. This leaves £2k (<1%) outstanding from the original outstanding amount of £1.014m.

4.4 Affordability Prudential Indicators

4.4.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

4.4.2 **Ratio of Financing Costs to Net Revenue Stream -** This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	Original Estimate 2020/21 £000	**Forecast Quarter 2 2020/21 £000**
Financing Costs		
Capital Financing Costs	1.798	1.647
Interest Receivable	(0.300)	(0.239)
A	1.498	1.408

Revenue Stream		
Government Grants	3.210	6.654
Retained Business Rates	5.732	5.585
Council Tax	27.756	27.756
B	36.70	40.00
Ratio (A divided by B as a percentage)	4.08%	3.52%

4.4.3 The estimates of financing costs include current commitments and the proposals in the budget report.

5 CAPITAL INVESTMENT STRATEGY

5.1 Continued reductions in Government funding and reduced investment income from traditional Treasury Management investments are still anticipated reinforcing the need for the Council to maximise income from other sources. In its efficiency plan (Report 151/2016) approved by Council in September 2016, the Council noted that one of its strategies for reducing the gap in the MTFP was to make better use of assets/capital resources: “The Council recognises that investing in new assets or enhancing/making better use of existing assets can have a beneficial impact in terms of a revenue payback or reducing revenue costs. Officers have been asked to bring forward proposals to be considered”

5.2 The Capital Investment Strategy published alongside the TMS identified the key principles of:

- Focus capital investment on delivery of council objectives and priorities
- Maximise and promote best use of available funds
- Ensure strong governance over decision-making
- Ensure plans are affordable, prudent and sustainable

5.3 Commercial investments are made in accordance with the Commercial Investment Policy which details the criteria and minimum requirements for appraising potential investments.

5.4 During the first 6 months of 2020/21 no commercial investments have been identified.

Appendix B. Link Asset Services Commentary on the Economy and Interest Rates

ECONOMICS UPDATE

As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in GDP in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the unemployment rate was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI inflation to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

It also squashed any idea of using negative interest rates, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be "less effective as a tool to stimulate the economy" at this time when banks are worried about future loan losses. It also has "other instruments available", including QE and the use of forward guidance.

In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to downside risks, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1st November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid September.

Overall, the pace of recovery is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.

There will be some painful longer term adjustments as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.

One key addition to the Bank's forward guidance was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate

US. The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked its inflation target from 2% to maintaining an average of 2% over an unspecified time period i.e.following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

EU. The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.

China. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

Japan. There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

World growth. Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 11th August 2020 (PWLB rates are certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6th August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

GILT YIELDS / PWLB RATES. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. At the close of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **UK** - second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- **US – the Presidential election in 2020:** this could have repercussions for the US economy and SINO-US trade relations.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

Appendix C: Treasury Management Glossary of Terms

Authorised Limit (Also known as the Affordable Limit): A statutory limit that sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities).
Balances and Reserves: Accumulated sums that are maintained either earmarked for specific future costs or commitments or generally held to meet unforeseen or emergency expenditure.
Bank Rate: The official interest rate set by the Bank of England's Monetary Policy Committee and what is generally termed at the "base rate". This rate is also referred to as the 'repo rate'.
Basis Point: A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent). In most cases, it refers to changes in interest rates and bond yields. For example, if interest rates rise by 25 basis points, it means that rates have risen by 0.25% percentage points. If rates were at 2.50%, and rose by 0.25%, or 25 basis points, the new interest rate would be 2.75%.
Bond: A certificate of debt issued by a company, government, or other institution. The bond holder receives interest at a rate stated at the time of issue of the bond. The price of a bond may vary during its life.
Capital Expenditure: Expenditure on the acquisition, creation or enhancement of capital assets.
Capital Financing Requirement (CFR): The Council's underlying need to borrow for capital purposes representing the cumulative capital expenditure of the local authority that has not been financed.
Capital Receipts: Money obtained on the sale of a capital asset.
Credit Rating: Formal opinion by a registered rating agency of a counterparty's future ability to meet its financial liabilities; these are opinions only and not guarantees.
Counterparty List: List of approved financial institutions with which the Council can place investments with.
Debt Management Office (DMO): The DMO is an Executive Agency of Her Majesty's Treasury and provides direct access for local authorities into a government deposit facility known as the

DMADF. All deposits are guaranteed by HM Government and therefore have the equivalent of a sovereign triple-A credit rating.
Gilts: Gilts are bonds issued by the UK Government. They take their name from 'gilt-edged'. Being issued by the UK government, they are deemed to be very secure as the investor expects to receive the full face value of the bond to be repaid on maturity.
LIBID: The London Interbank Bid Rate (LIBID) is the rate bid by banks on Eurocurrency deposits (i.e. the rate at which a bank is willing to borrow from other banks).
LIBOR: The London Interbank Offered Rate (LIBOR) is the rate of interest that banks charge to lend money to each other. The British Bankers' Association (BBA) work with a small group of large banks to set the LIBOR rate each day. The wholesale markets allow banks who need money to be more fluid in the marketplace to borrow from those with surplus amounts. The banks with surplus amounts of money are keen to lend so that they can generate interest which it would not otherwise receive.
Maturity: The date when an investment or borrowing is repaid.
Money Market Funds (MMF): Pooled funds which invest in a range of short term assets providing high credit quality and high liquidity.
Minimum Revenue Provision (MRP): An annual provision that the Council is statutorily required to set aside and charge to the Revenue Account for the repayment of debt associated with expenditure incurred on capital assets.
Voluntary Revenue Provision (VRP): An additional contribution over and above the MRP that the Council can choose to make to reduce the CFR which in turn will reduce the MRP for future years.
Non Specified Investment: Investments which fall outside the MHCLG Guidance for Specified investments (below).
Operational Boundary: This linked directly to the Council's estimates of the CFR and estimates of other day to day cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.
Prudential Code: Developed by CIPFA and introduced on 01/4/2004 as a professional code of practice to support local authority capital investment planning within a clear,

affordable, prudent and sustainable framework and in accordance with good professional practice.

Prudential Indicators:

Prudential indicators are a set of financial indicators and limits that are calculated in order to demonstrate that councils' capital investment plans are affordable, prudent and sustainable.

They are outlined in the CIPFA Prudential Code of Practice. They are indicators that must be used to cover the categories of affordability, prudence, capital spending, external debt/borrowing and treasury management. They take the form of limits, ratios or targets which are approved by Council before 1 April each year and are monitored throughout the year on an on-going basis. A council may also choose to use additional voluntary indicators.

Public Works Loans Board (PWLB):

The PWLB is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.

Revenue Expenditure:

Expenditure to meet the continuing cost of delivery of services including salaries and wages, the purchase of materials and capital financing charges.

(Short) Term Deposits:

Deposits of cash with terms attached relating to maturity and rate of return (Interest).

Specified Investments:

Term used in the MHCLG Guidance and Welsh Assembly Guidance for Local Authority Investments. Investments that offer high security and high liquidity, in sterling and for no more than one year. UK government, local authorities and bodies that have a high credit rating.

Supported Borrowing:

Borrowing for which the costs are supported by the government or third party.

Temporary Borrowing:

Borrowing to cover peaks and troughs of cash flow, not to fund capital spending.

Unsupported Borrowing:

Borrowing which is self-financed by the local authority. This is also sometimes referred to as Prudential Borrowing.

Yield:

The measure of the return on an investment.