

COUNCIL MEETING - 15 DECEMBER 2020

TREASURY MANAGEMENT 2020-21 MID YEAR REPORT

1. Purpose of Report

1.1. This report provides an update on the Council's treasury activity and prudential indicators for the first half of 2020/21. This was reported to the Audit & Accounts Committee on 25 November 2020.

2. Summary of Treasury Balances as at 30 September 2020

2.1. Below is a summary of the Council's borrowing position as at 30 September 2020, further information at section 6.

Balance on 01/04/2020 £m		Balance on 30/09/2020 £m
92.427	Total Borrowings	99.638
0.224	Total Other Long Term Liabilities	0.224
92.651	TOTAL EXTERNAL DEBT	99.862

2.2. Below is a summary of the Council's investment position as at 30 September 2020, further information at section 7.

Balance on 01/04/2020 £m		Balance on 30/09/2020 £m
30.959	Total Short term Investments	49.522
7.500	Total Long term Investments	7.500
92.651	TOTAL INVESTMENTS	57.022

2.3. Below is a summary of the Council's capital expenditure position as at 30 September 2020, further breakdown at section 5.

Capital Expenditure	2020/21 Initial Capital Budget £m	Current Expenditure 30/09/2020 £m	2020/21 Revised Estimate £m
General Fund Expenditure	29.227	1.645	32.537
HRA Expenditure	23.909	4.179	24.379
Total Capital Expenditure	53.136	5.824	56.916

2.4. **Breach of Indicator**, the Council can confirm no prudential indicators were breached during the first six months of financial period 2020/21, further breakdown at section 9.

3. Introduction

3.1. This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit and Accounts Committee.

3.2. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2020/21 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's investment portfolio for 2020/21;
- A review of the Council's borrowing strategy for 2020/21;
- A review of any debt rescheduling undertaken during 2020/21;
- A review of compliance with Treasury and Prudential Limits for 2020/21.

3.3. Treasury Management is defined as: "The management of the local authority's borrowing, 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".

3.4. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

4. Treasury Management Strategy Statement (TMSS) and Annual Investment Strategy Update

4.1. The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by Full Council on 9 March 2020. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5. The Council's Capital Position

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1. The table below shows the revised estimates for capital expenditure and the changes since the Capital Programme was agreed within the Capital Programme budget on 9 March 2020.

Capital Expenditure	2020/21 Capital Budget approved 9 March 2020 £m	Current Expenditure £m	2020/21 Revised Estimate £m
General Fund Expenditure	29.227	1.645	32.537
HRA Expenditure	23.909	4.179	24.379
Total Capital Expenditure	53.136	5.824	56.916
Financed by:			
Capital Receipts	5.298		4.863
Capital Grants & Contributions	9.203		8.809
Capital Reserves	12.111		12.965
Revenue	2.787		3.620
Total Financing	29.399		30.257
Borrowing Requirement	23.737		26.659

The financing of the Capital Programme will be determined by the S151 Officer at the year-end based on best use of resources.

The increase from the Budget approved 9 March 2020 relates to approved capital carry forward requests and approved variations to the capital programme.

6. Borrowing Strategy

6.1. At 30 September 2020 the Council held £99m of loans, as part of its strategy for funding previous years' capital programmes.

6.2. Borrowing Activity in 2020/21

	General Fund		HRA	
	Balance on 01/04/2020 £m	Balance on 30/09/2020 £m	Balance on 01/04/2020 £m	Balance on 30/09/2020 £m
Short Term Borrowing	1.071	0.795	4.026	4.014
Long Term Borrowing	3.300	3.300	84.030	91.530
TOTAL BORROWING	4.371	4.095	88.056	95.543
Other Long Term Liabilities	0.224	0.224	0	0
TOTAL EXTERNAL DEBT	4.595	4.319	88.056	95.543
CFR	26.262	44.778	106.638	110.211
Under / (over) borrowing	21.667	40.459	18.582	14.668

6.3. As the Council is in a significant under borrowed position, as per the table in 6.2, there may be a requirement during the remainder of the financial year where new borrowing is required. Below is a breakdown of new borrowing taken during financial year 2020/21 which was within the approved Treasury Management Borrowing Strategy framework and has been reviewed by the S151 Officer for cost effectiveness as whether to borrow shorter term or long term in relation to interest rate forecasts.

Institution	From	To	Amount	Rate
PWLB	01/04/2020	31/03/2038	£3,000,000	1.46%
PWLB	01/04/2020	31/03/2045	£4,500,000	1.55%

6.4. **LOBOs:** The Council holds £3.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of the £3.5m of LOBOs had options during the last 6 months, none of which were exercised by the lender. The Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

6.5. **Internal borrowing:** For the Council, the use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding of capital expenditure that has not been funded from grants and other resources. This has lowered overall treasury risk by reducing both external debt and temporary investments. However this position will not be sustainable over the medium term as the Council needs to use reserves for the purpose they were set aside for, and external borrowing may need to be undertaken.

6.6. **Debt rescheduling:** The premium charge for early repayment of PWLB debt remains relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken or is proposed during the rest of the financial year as a consequence.

7. Investment Activity

7.1. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a return commensurate with these principles.

7.2. Investment Activity in 2020/21

Type of Investment	Balance on 01/04/2020 £m	Balance on 30/09/2020 £m	Average Interest Rate
Short term Investments			
<i>Fixed Term Deposits:</i>			
Santander	5.000	5.000	0.55%
Lloyds 95 Day Notice	0	5.000	0.20%
Local Authority Investment	3.000	8.000	1.00%
Close Brothers	0	2.000	0.45%
<i>Money Market Funds:</i>			
Goldman Sachs	6.800	4.572	0.01%
Deutsche Bank	5.159	1.060	0.01%
Invesco	8.500	12.000	0.04%
CCLA	2.500	7.240	0.13%
<i>Bank Call Account:</i>			
Handelsbanken	0	4.650	0.05%
Total Short Term Investments	30.959	49.522	
Long term Investments			
CCLA Property Fund	4.000	4.000	3.64%
CCLA Diversified Income Fund	3.500	3.500	3.80%
Total Long Term Investments	7.500	7.500	
TOTAL INVESTMENTS	38.459	57.022	
Increase/ (Decrease) in Investments		18.563	

7.3. Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

7.4. The Council's budgeted investment return for 2019/20 is currently forecasting an £0.302m unfavourable variance. As shown by the interest rate forecasts in section 2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low.

8. Non-Treasury Investments

8.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return or regeneration purposes. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return or regeneration purposes.

8.2. Breakdown below of current Non-Treasury Investments held;

Counterparty	Balance at 30/09/2020
Growth Investment Fund	£40,935
Loans to Housing Associations	£19,222
Loans to Parish Councils	£15,958
Loans to RHH Ltd	£707,890

These investments are due to generate £0.031m of investment income for the Council after taking account of direct costs, representing a rate of return of 5.14%.

9. Prudential Indicators

Breach of Indicators

9.1. There have been no breaches of the prudential indicators in the first six months of the financial year 2020/21.

Limit To Borrowing Activity

9.2. **Authorised Limit and Operational Boundary for External Debt.** The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. The s151 Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2020/21.

	Approved Operational Boundary 2020/21 £m	Authorised Limit 2020/21 £m	Actual External Debt 30/09/2020 £m	Compliance
Borrowing	161.9	168.5	99.6	Yes
Other Long Term Liabilities	0.4	0.6	0.2	Yes
Total	162.3	169.1	99.9	Yes

- 9.3. **Maturity Structure of Fixed Rate Borrowing.** This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

	Upper Limit %	Actual at 30/09/2020 £m	Actual at 30/09/2020 %	Compliance
Under 12 months	15%	4.00	4.05%	Yes
12-24 months	15%	6.30	6.37%	Yes
2-5 years	30%	16.00	16.19%	Yes
5-10 years	100%	23.77	24.05%	Yes
Over 10 years	100%	48.77	49.34%	Yes

Limits to Investing Activity

- 9.4. **Security.** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Target	Actual	Compliance
Portfolio average credit rating	A	AA+	Yes

- 9.5. **Liquidity Risk Indicator.** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a banding period, without additional borrowing.

Total cash available within;	Limit	Actual 30/09/2020	Compliance
3 months	100%	52%	Yes
3 – 12 months	80%	35%	Yes
Over 12 months	40%	13%	Yes

- 9.6. **Principal Sums Invested for over 364 Days.** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments

	Price Risk Limit 2020/21	Actual Investment 30/09/2020	Compliance
Limit on principal invested beyond year end	£15m	£7.5m	Yes

Limits to Capital Activity

9.7. **Capital Financing Requirement.** The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose.

	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
CFR – non housing	27.151	44.778
CFR – housing	104.835	110.211
Total CFR	131.986	154.989
Net movement in CFR		23.003

9.8. **Capital Financing Costs to Net Revenue Stream.** Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
General Fund		
Financing Costs	-0.291	-0.291
Proportion of net revenue stream	-1.48%	-1.48%
Housing Revenue Account		
Financing Costs	11.731	12.187
Proportion of net rental stream	50.33%	53.78%

10. Economic Background/Interest Rate Forecast

10.1. **Appendix A and Appendix B** gives a summarised outlook for the economic background and interest rate forecast from our Treasury Consultants, Link.

11. RECOMMENDATIONS

That the treasury management activity and Prudential Indicators be noted.

Background Papers

Nil.

For further information, please contact Andrew Snape, Assistant Business Manager – Financial Services on extension 5523.

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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.

The MPC expected the £300bn of quantitative easing purchases announced between its March and June meetings to continue until the “turn of the year”. This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.

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.

The Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

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)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

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.