Manchester City Council
Report for Information

Report to: Audit Committee – 26 November 2020

Subject: Treasury Management Interim Report 2020-21

Report of: Deputy Chief Executive and City Treasurer

Summary

To report the Treasury Management activities of the Council during the first six months of 2020/21.

Recommendation

The Audit Committee is asked to note the contents of the report

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Wards Affected: Not Applicable

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Background documents (available for public inspection):

Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2020-21 (Executive – 12th February 2020, Resource and Governance Scrutiny Committee – 24th February 2020, Council – 6th March 2020)

1 Introduction and Background

1.1 Treasury Management in Local Government is regulated by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in Local Authorities (the Code). The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer Responsibilities, and delegation and reporting arrangements.

1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2009, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement (TMSS), the requirement to report to members at least twice a year on the activities of the Treasury Management function. The recommendation was first included within the 2010/11 TMSS approved by the Executive on the 10th February 2010. The requirement has also been included and approved as part of each the annual TMSS since 2010/11. This report therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.

1.3 The Code was revised in 2017 and this report has been prepared in accordance with the revised Code. The sections of this report are shown below:

Section 1: Introduction and Background
Section 2: Portfolio Position as at 30th September 2020
Section 3: Review of Economic Conditions 2020-21 to date
Section 4: Public Works Loans Board (PWLB) Consultation
Section 5: Treasury Borrowing in 2020-21 to date
Section 6: Compliance with Prudential Indicators and Treasury Limits
Section 7: Investment Strategy for 2020-21 to date
Section 8: Temporary Borrowing and Investment for 2020-21 to date
Section 9: Negative Rates and Transition Period Ending
Section 10: Conclusion

Appendix A: Public Works Loans Board (PWLB) Interest Rates
Appendix B: Treasury Management Prudential Indicators
Appendix C: Review of Economic Conditions, provided by advisors
Appendix D: Glossary of Terms

2 Portfolio Position as at 30th September 2020

2.1 As outlined in the approved TMSS for 2020/21 it is anticipated that there will be a need to undertake some permanent borrowing in 2020/21 to fund the capital programme and to replace some of the internally borrowed funds.

2.2 The Council has faced some unparalleled circumstances during the COVID-19 pandemic creating a challenging market environment in which the Council must conduct its treasury management activities. The last six months have put a significant strain on the availability of cash due to reduced income from business rates, council tax, and other forms of income. In such a turbulent market environment, liquidity is extremely important and ensuring cash is available to support both COVID-19 related activity and the underlying budgeted activity is paramount.

2.3 Temporary borrowing has been required during the first half of the year, with further borrowing likely to be required during the second half of the year. The Council's debt position at the beginning of the financial year and at the end of September is compared in the table below:

Loan Type	31 March 2020				30 September 2020			
	GF	HRA	Principal	Avg. Rate	GF	HRA	Principal	Avg. Rate
	£m	£m	£m	%	£m	£m	£m	%
PWLB	150.0	0.0	150.0	2.45	150.0	0.0	150.0	2.45
Temporary Borrowing	30.8	0.0	30.8	0.98	209.9	0.0	209.9	0.98
Market Loans	336.8	61.9	398.7	4.48	336.8	61.9	398.7	4.48
Stock	0.9	0.0	0.9	4.00	0.9	0.0	0.9	4.00
Government Lending	26.8	0.0	26.8	0.00	25.5	0.0	25.5	0.00
Gross Total	**545.3**	**61.9**	**607.2**	**3.60**	**723.1**	**61.9**	**785.0**	**3.01**
Temporary Deposits	(128.4)	0.0	(128.4)	0.33	(66.6)	0.0	(66.6)	0.21
Internal Balances (GF/HRA)	42.3	(42.3)	0.00	0.00	50.3	(50.3)	0.0	0.00
Net Total	**459.2**	**19.6**	**478.8**	**-**	**706.8**	**11.6**	**718.4**	**-**

2.4 The temporary borrowing and deposit figures fluctuate daily to meet the ongoing cash flow requirements of the Council. The figures for these categories in the table above are therefore only a snapshot at a particular point in time.

2.5 In line with the requirements noted in the TMSS, and to provide cash flow stability, short term borrowing of £179.1m was taken by the end of September 2020. The borrowing consisted of cash on notice to allow for the repayment of borrowing if the cash flow position was to improve throughout the year, as well as 364 day fixed maturities, and 2 year fixed maturities. The loans were mainly sourced from other local authorities, and the rates reflected the low rate environment.

2.6 Total Government Debt dropped from £26.8m to £25.5m due to the repayment of £1.3m SALIX loans.

2.7 Total debt has therefore increased by £177.8m during the first six months of 2020/21.

2.8 The cash flow forecast suggests the level of deposits will continue to fall resulting in further temporary borrowing being required prior to year-end. Ongoing research is taking place to find suitable short term and long term borrowing. Any such activity will be reported in the outturn report.

3 Review of Economic Conditions 2020-21 to date

3.1 The Bank of England maintained the lending rate at 0.10% in the first half of the financial year. In March 2020 the Bank of England dropped the key lending rate initially from 0.75% to 0.25% followed by a further reduction to 0.10% on the 19th of March 2020 in efforts to stimulate the economy during COVID-19.

3.2 Appendix C provides a more detailed review of the economic situation.

4 Public Works Loans Board (PWLB) Consultation

4.1 The Council has access to the Public Works Loan Board (PWLB) for debt, which is an executive agency of HM Treasury. Acting as a lender to the local authority sector, it provides debt at interest costs closely linked to the equivalent debt costs of Government, known as Gilts.

4.2 As noted in the previous outturn report for 2019/20, the PWLB changed its policy to increase the margin from Gilts plus 100 basis points to Gilts plus 200 basis points, and therefore the margin on the Certainty Rate, which local authorities can apply for, to Gilts plus 180 basis points. This means that forecast interest costs on future debt increased substantially, though remained below the level budgeted for. Interest rates on PWLB debt the Council already hold have not changed.

4.3 The government launched a consultation to work with local authorities to develop a targeted intervention to stop 'debt-for-yield' activity while protecting the crucial work the local authorities perform on service delivery, housing, and regeneration. When announcing the consultation government suggested that the intention is that if PWLB borrowing for 'debt-for-yield' activity can be curtailed they would look to reduce the margin on PWLB interest rates above Gilts, which currently stands at 2.00%. The consultation was intended to finish in early June, but due to COVID-19 it was extended until the end of July.

4.4 The decision to increase the rate by 100bps has made new PWLB borrowing significantly more expensive. The market has shown some debt offers cheaper than PWLB, but still more expensive compared to pre-rise PWLB levels. The outcome of the consultation is awaited as it will determine the scale of the future debt costs the Council may face, and the timing of when the Council may seek to take longer term debt. Officers continue to assess the market to determine the optimum approach.

5 Treasury Borrowing in 2020-21 to date

PWLB

5.1 PWLB interest rates during the first 6 months of the year are illustrated in the table below and the graph at Appendix A.

PWLB Standard Borrowing Rates 2020-21 to date for 1 to 50 years					
	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**
Low	1.90%	1.87%	2.11%	2.60%	2.33%
Date	18/09/2020	30/07/2020	31/07/2020	18/06/2020	24/04/2020
High	2.14%	2.19%	2.39%	3.00%	2.85%
Date	08/04/2020	08/04/2020	08/04/2020	28/08/2020	28/08/2020
Average	2.00%	2.00%	2.24%	2.74%	2.53%

5.2 Manchester continues to be on the approved list of authorities that can access the PWLB Certainty Rate going forward, giving the Council access to a 20 basis points reduction on the published PWLB rates in the previous table.

Temporary Borrowing

5.3 As noted in the previous section, following conclusion of the consultation and subject to market conditions, PWLB may look to reduce the margin on the interest rates they offer. Therefore, Treasury Management have focused on temporary borrowing as described in paragraph 2.5.

5.4 Work will continue to identify debt opportunities, in the context of the PWLB consultation, and to continue to have in place a debt strategy which balances the risks to the Council if, for example, PWLB rates do not fall.

Salix Borrowing

5.5 Salix Finance Ltd provides interest-free Government funding to the public sector to improve their energy efficiency, reduce carbon emissions and lower energy bills. The supported scheme in relation to LED lighting Council projects will be repaid by 1st April 2023.

5.6 In the first half of the year, the Council repaid £1.3m, bring the total value of Salix debt to £17.1m on 30th of September 2020.

6 Compliance with Prudential Indicators and Treasury Limits

6.1 As outlined in Section 21 of the Capital Budget Monitoring Report at the end of June 2020, the prudential indicators had to be revised to reflect the additional capital expenditure, financial support to Manchester Airport Group, which was not part of the budget in February 2020 on which the prudential indicators were based. The Council operated within the updated prudential indicators, and performance against these is shown in Appendix B.

6.2 Further to this, the Council sets an operational limit on the cleared balance that is left within the Council's current accounts. The limit is aimed at minimising the cash held in these accounts which attracts no interest and thereby maximises the investment return for the authority. The limit is set at £400k and this was met during the first half of the financial year with the exception of the breaches described below.

6.3 Where the limit is breached it means that the Council either incurred interest costs due to being in an overdraft position or lost potential investment income due to excess cash not being invested. It is important to note that any such breach will be rectified the following working day, and therefore the financial impact is minimised.

6.4 During the period 1st April to 30th September 2020 there were twenty-one breaches of the daily £0-400k limit on the Barclays current account.

i. On twenty occasions, Treasury Management purposely kept the current account in surplus to enable the Shared Service Centre to process COVID-19 Business Support Grants throughout the evening and following early morning. This arrangement ensured the payments were processed in time mitigating the risk of payments not being made due to the lack of funds.
ii. On the final occasion, the limit was breached due to various late afternoon receipts which the Treasury Management team had not been made aware of. Where possible, officers are asked to inform the team of any expected receipts or payments over £50k in order to efficiently manage cash.

6.5 Each breach was notified to the Deputy Chief Executive and City Treasurer and action taken on the following working day to bring balances back within approved limits. No additional costs arose as a result, other than the opportunity cost incurred of not investing the surplus cash, which in the current interest market is minimal.

7 Investment Strategy for 2020/21 to date

7.1 The Treasury Management Strategy Statement (TMSS) for 2020-21 was approved by Executive on 12th February 2020. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as:

- (a) the security of capital; and
- (b) the liquidity of investments.

7.2 The TMSS for 2020/21 contained a number of measures to broaden the Council's treasury management investment base, including the use of five Money Market Funds (MMFs).

7.3 The current strategy means that a significant proportion of the Council's investments are with the chosen MMFs and other local authorities. This highlights the relatively low rate of credit risk that the Council takes when investing.

7.4 It should be noted that, whilst seeking to broaden the investment base, officers will continue to seek high quality investments to limit the level of risk taken by the Council. It is not expected that the measures considered above will have a significant impact on the rates of return the Council currently achieves.

7.5 During the financial year the Council's temporary cash balances have been managed by the Deputy Chief Executive and City Treasurer in-house and invested with those institutions listed in the Council's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy agreed at Executive in February and Council in March.

8 Temporary Borrowing and Investment for 2020/21 to date

8.1 The first six months of the financial year have, as noted above, been unparalleled. Cash flows have been less than predictable, with some payments or income being made or received at short notice. This has required a strong focus on liquidity to ensure that cash is available when required.

8.2 To ensure that liquidity is managed, and in recognition of the unpredictability of the cash flow, temporary borrowing was sought early in the period. This supported the fact that the timing of some significant payments was uncertain, but has meant that the average level of investments is relatively high across the period, albeit this masks a consistently falling balance, as can be seen in the table at paragraph 2.3.

8.3 Investment rates available in the market continue to be at an historic low point. The average level of funds available for investment purposes in the first six months of 2020/21 was £143.0m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, the receipt of grants, payments of COVID-19 related grants, progress on the capital programme, and working capital.

8.4 Short term temporary borrowing was taken in the first half of the year to support the cash flow, as anticipated in the TMSS for 2020/21, and to manage the cash flow impact of COVID-19. The average level of temporary borrowing in this period was £179.4m.

8.5 Detailed on the next table is the temporary investment and borrowing undertaken by the Council. As illustrated, the Council over performed the benchmark by 33 basis points on investments due to the effective search for better inter Local Authority market rates and the use of Money Market Funds which on average had a higher return.

8.6 The temporary borrowing portfolio consisted of loans with various investment tenors ranging from 14 day notice terms to fixed two-year maturities. The average cost was therefore higher by 31 basis points when compared to the 12 month benchmark rate demonstrating value for money as the rate curve extends.

8.7

	Average temporary investment /borrowing	Net Return/Cost	Benchmark Return / Cost *
Temporary Investments	£143.0m	0.27%	-0.06%
Temporary Borrowing	£179.4m	0.76%	0.45%

** Average 7-day LIBID/12-month LIBOR rate*

8.8 None of the institutions in which investments were made, such as banks, local authorities and MMFs, showed any difficulty in repaying investments and interest during the year. The list of institutions in which the Council invests is kept under continuous review.

9 Negative Rates and Transition Period Ending

9.1 The possibility of future negative interest rates in the UK is unprecedented, but still remains a viable tool for the Bank of England. Officers are assessing the impact negative rates could have on the Council's debt and investment strategies.

9.2 The Debt Management Office (DMO) began offering investments at a negative interest rate on the 25th of September 2020. This means if the Council were to place cash with the DMO, there would be a cost for making that investment. In the current environment, officers view this as an option of last resort if a positive interest rate is achievable elsewhere.

9.3 There is a risk the market will enter an environment where the conditions do not allow for a positive return in the short term. If this were to happen, the investment strategy would shift focus onto minimising costs while ensuring security of cash and reasonable liquidity.

9.4 There are also risks associated with the end of the UK's transition period after Brexit on the 31st of December 2020. Officers will continue to monitor the financial markets and look to pursue an investment and debt strategy which minimises the risk to the authority.

10 Conclusion

10.1 The first six months of year 2020/21 have so far demonstrated extraordinary market conditions putting enormous pressure on the Council's cash liquidity. The next six months are likely to further put more pressure on the Council's income and therefore cash flow. Cash balances have been low during the first half of the year and based on current forecasts an additional borrowing requirement is expected during the second half of 2020/21.

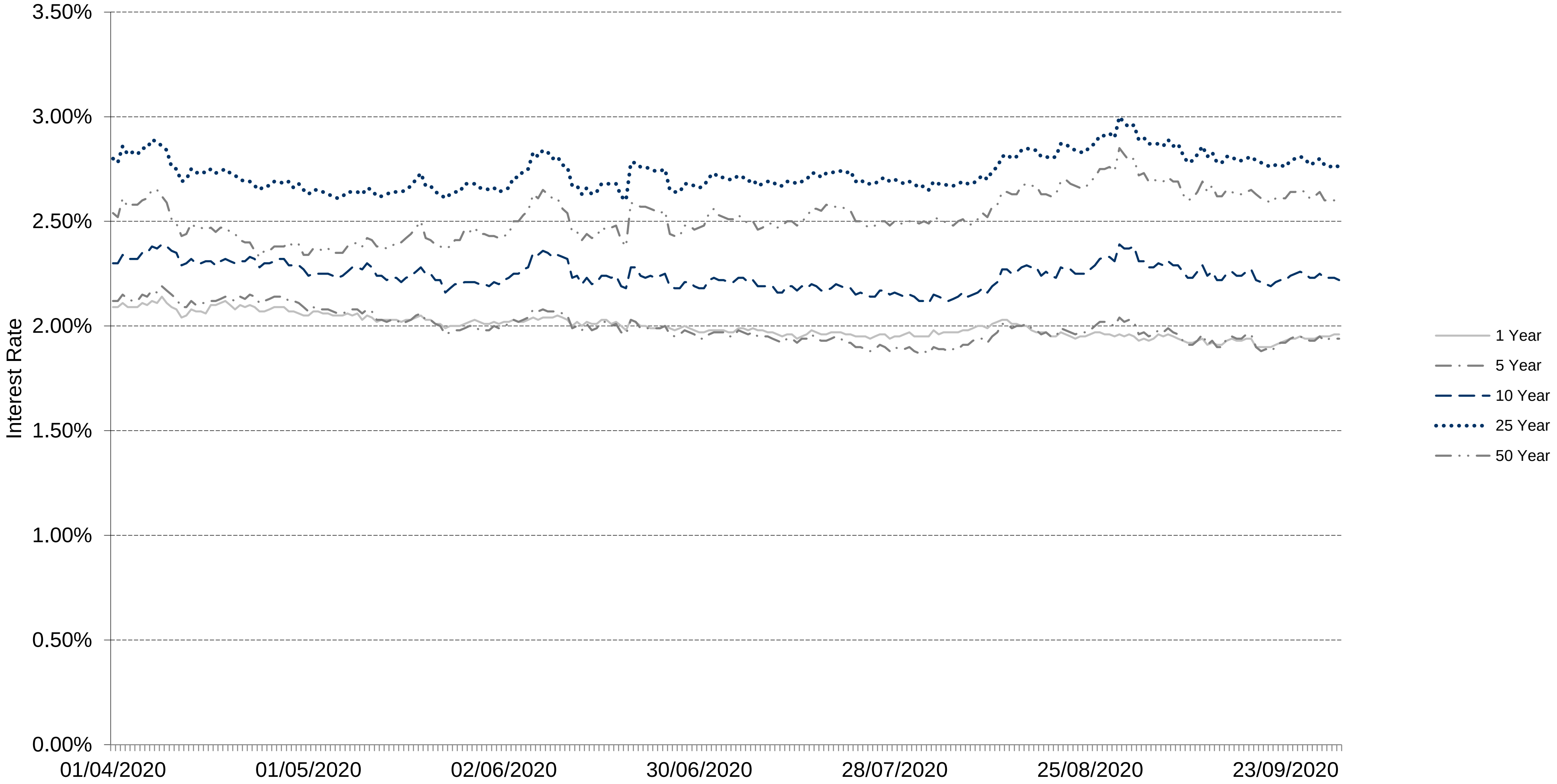
10.2 The current borrowing position reflects the strong balance sheet of the Council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows, etc). The Council's policy remains to keep cash as low as possible and not to borrow in advance of need for capital purposes.

10.3 Proactive treasury management during the year has enabled the Council to achieve an average net return on investments of 0.27%, in excess of the benchmark average 7-day LIBID rate of -0.06% and also higher than the rate offered by the DMO, which is the default option if there are no other investment opportunities based on the credit criteria set.

10.4 The change in policy for the PWLB has challenged the local authority debt environment, and it is anticipated that it will take some time before PWLB formally replies to the consultation that finished at the end of July 2020. Officers will continue monitoring the market, and engage with market participants including banks, investment firms, brokers and advisors to review the debt opportunities available to the Council particularly in light of the potential changes in the interest rate and the EU transition.

APPENDIX A

PWLB RATES APRIL TO SEPTEMBER 2020



APPENDIX B

Treasury Management Prudential Indicators: 2020-21 to date

	Original ***£m***	**Minimum In Year to 30 Sept 2020** ***£m***	**Maximum In Year to 30 Sept 2020** ***£m***
Operational Boundary for External Debt:			
Borrowing	1,006.2	680.8	785.1
Other Long Term Liabilities	216.0	157.6	161.5
Authorised Limit for External Debt:			
Borrowing	1,384.5	680.8	785.1
Other Long Term Liabilities	216.0	157.6	161.5
		Actual as at 30 Sept 2020	
Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

Maturity structure of Fixed Rate Borrowing	**Lower Limit 2020-21 Original**	**Upper Limit 2020-21 Original**	**Actual as at 30 Sept 2020**
under 12 months	0%	80%	44%
12 months and within 24 months	0%	70%	17%
24 months and within 5 years	0%	60%	9%
5 years and within 10 years	0%	50%	1%
10 years and above	20%	80%	29%

APPENDIX C

REVIEW OF ECONOMIC CONDITIONS FOR FIRST SIX MONTHS OF 2020-21 AND FUTURE OUTLOOK

This section has been prepared by the Council's Treasury Advisors, Link Asset Services, for the 30th of September 2020 and includes their forecast for future interest rates after the PWLB policy change referenced in the report.

1 ECONOMIC PERFORMANCE TO DATE 2020-21

1.1 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.

1.2 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 quantitative easing (QE) and the use of forward guidance.

1.3 The MPC expected the £300bn of QE 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.

1.4 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.

1.5 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.

1.6 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.

1.7 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.

1.8 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%.

1.9 **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.

1.10 **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.

1.11 **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.

1.12 **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.

1.13 **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.

2 INTEREST RATE FORECAST

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

2.1 Additional notes by Link on this forecast table: -

- Please note that we have made a slight change to our interest rate forecasts table above for forecasts for 3, 6 and 12 months. Traditionally, we have used LIBID forecasts, with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that all LIBOR rates up to 6 months are currently running below 0.1%, using that convention would give negative figures as forecasts for those periods. However, the liquidity premium that is still in evidence at the short end of the curve, means that the rates actually being achieved by local authority investors are still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 0.05% is achievable for 3 months, 0.1% for 6 months and 0.15% for 12 months.
- During 2021, Link will be continuing to look at market developments in this area and will monitor these with a view to communicating with clients when full financial market agreement is reached on how to replace LIBOR. This is likely to be an iteration of the overnight SONIA rate and the use of compounded rates and Overnight Index Swap (OIS) rates for forecasting purposes.
- If clients require forecasts for 3 months to 12 months beyond the end of 2021, a temporary fix would be to assume no change in our current forecasts.

2.2 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.

3 GILT YIELD / 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.

3.1 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%.

3.2 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).

3.3 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)

3.4 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.

3.5 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.

4 THE BALANCE OF RISKS TO THE UK

4.1 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.

4.2 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.

4.3 **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.

4.4 **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 D

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Constant Net Asset Value (CNAV) – refers to Funds which use amortised cost accounting to value all of their assets. The aim is to maintain a Net Asset Value (NAV), or value of a share of the Fund at £1.

Counterparty – one of the opposing parties involved in a borrowing or investment transaction

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

LIBID (London Interbank Bid Rate) – This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) – This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) – This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market - The private sector institutions **-** Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Monetary Policy Committee – the independent body that determines Bank Rate.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government's Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more then one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside the Council's minimum credit rating criteria.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan.
A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.