Midlothian

Audit Committee
Tuesday 8 December 2020
Item No 5.6

**Treasury Management Mid-Year Review Report 2020/21**

**Report by Gary Fairley, Chief Officer Corporate Solutions**

**Report for Consideration**

## 1 Recommendations

The Audit Committee is invited to comment on this report before the final report is presented to Council. In particular, Audit Committee should note the following recommendations which are proposed to be put to Council on 15 December 2020:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2020, as outlined in Section 5;
b) Note the forecast activity during the second-half of the year as outlined in Section 6;
c) Approve the Prudential Indicators in Section 7 of this report.

## 2 Purpose of Report/Executive Summary

The purpose of this report is to inform members of the Audit Committee, and subsequently Council, of the Treasury Management activity undertaken during the first half of 2020/21, the forecast activity for the second half of 2020/21 and an update to the Treasury and Prudential Indicators for 2020/21.

**Date: 23 November 2020**

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## 3 Background

Audit Committee Role

The Prudential Code recommends that the main Treasury Management reports are presented for scrutiny by Audit Committee in advance of consideration by Council. This report is being presented to Audit Committee on 8 December 2020 for consideration prior to being presented to Council on 15 December 2020. Any revisions arising from Audit Committee consideration of the report on 8 December 2020 will be incorporated into the final version of the report to Council on 15 December 2020.

Treasury management

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

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.

Accordingly, 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."*

Council, on 11 February 2020, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2020/21.

## 4 Economic update for first half of 2020/21

An economic update for the first part of the 2020/21 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2.

## 5 Treasury Activity during first half of 2020/21

The main points arising from treasury activity in the year to 30 September 2020 were:-

- Taking advantage of the historically low PWLB rates and the HRA discounted rate in the first half of the year, a new £15.000 million long term loan was sourced from PWLB on 28 April 2020 with a 46.5 year tenor at a fixed interest rate of 1.17%;
- Long term borrowing of £0.552 million matured, this being £0.319 million of Market Loans, £0.183 million of Salix loans and £0.020 million PWLB Annuities;
- Three short term investments beyond a duration of 1 year were placed:-
  - £13.000 million fixed term deposit for 2.5 years, placed with London Borough of Croydon on 3 April 2020, earning an interest rate return of 1.85% per annum;
  - £2.000 million fixed term deposit for 3 years, placed with Stoke on Trent City Council on 6 April 2020, earning an interest rate return of 1.60% per annum;
  - £15.000 million fixed term deposit for 2 years, placed with London Borough of Waltham Forest on 30 April 2020, earning an interest rate return of 1.25% per annum;
- One short-term investment of £30.000 million with Bank of Scotland matured on 26 June 2020. This short-term investment was originally placed on 26 June 2019 for a period of 1 year at a fixed interest rate of 1.25%;
- The Scottish Government provided upfront funding to local authorities to support a range of grant schemes, in particular schemes to support local businesses. This, in addition to advanced Revenue Support Grant payments and Early Years Capital Grant payments in the spring/summer, has resulted in a large increase in investment balances and the level of temporary borrowing reduced to nil;
- The average interest rate earned on external investments was 1.05%, exceeding the benchmark rate of 0.41%.

The Council's loan and investment portfolio as at 30 September 2020 is shown in tables 1 and 2 below (position at 31 March 2020 also shown for comparison):-

Table 1: Council’s Loan Portfolio at 31 March 2020 and 30 September 2020.

| **Loan Type** | **31 March 2020** | | **30 September 2020** | |
|---|---|---|---|---|
| | **Principal Outstanding £000’s** | **Weighted Average Rate** | **Principal Outstanding £000’s** | **Weighted Average Rate %** |
| PWLB Annuity | 637 | 8.90% | 617 | 8.90% |
| PWLB Maturity | 228,824 | 3.41% | 243,824 | 3.27% |
| LOBO | 20,000 | 4.51% | 20,000 | 4.51% |
| Market Loans | 18,831 | 2.68% | 18,512 | 2.68% |
| Temporary Market Loans | 0 | n/a | 0 | n/a |
| Other Loans | 785 | 0.00% | 601 | 0.00% |
| **Total Loans** | **269,077** | **3.44%** | **283,555** | **3.33%** |
| | | | | |
| **Underlying Borrowing Requirement*** | **284,454** | | **288,299** | |
| **Internal Borrowing** | **15,377** | | **4,744** | |

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the “Public Private Finance” (PPP) Contract Liabilities*

Table 2: Council’s Investment Portfolio at 31 March 2020 and 30 September 2020

| **Investment Type** | **31 March 2020** | | **30 September 2020** | |
|---|---|---|---|---|
| | **Principal Outstanding £000’s** | **Weighted Average Rate** | **Principal Outstanding £000’s** | **Weighted Average Rate %** |
| Money Market Funds | 14,902 | 0.31% | 44,712 | 0.05% |
| Bank Call Accounts | 11,476 | 0.30% | 14,588 | 0.01% |
| Bank Notice Accounts | 14,985 | 1.10% | 14,985 | 0.70% |
| Bank Fixed Term Deposits | 30,000 | 1.25% | 0 | n/a |
| Deposits with other Local Authorities | 40,000 | 1.56% | 70,000 | 1.55% |
| **Total Investments** | **111,363** | **1.12%** | **144,285** | **0.84%** |

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields that has influenced PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

## 6 Expected Treasury Activity during second half of 2020/21

Borrowing

Long term borrowing of £8.843 million will mature in the second half of 2020/21, this being a £8.400 million maturity loan with PWLB, £0.321 million of Market Loans, £0.101 million of Salix loans and £0.021 million PWLB Annuities.

The £8.400 million maturity loan with PWLB which matures on 14 December 2020 has already been refinanced with new longer term PWLB borrowing.

It is expected that no further long-term borrowing will be sourced in the second half of 2020/21, and that if any borrowing is required, it will be sourced by temporary borrowing, taking advantage of the rates in this market sitting at less than the 0.10% Bank of England Base Rate.

However, given the current forecasts of capital expenditure and any revisions to these forecasts for 2020/21 and beyond as previously reported to Council, consideration will be given to borrowing now (for capital expenditure beyond 2020/21) if it is determined that this would offer value compared with forward interest rate projections. Equally, consideration will continue to be given as to whether any forward borrowing opportunities offer value (this would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher, eliminating the majority of the cost of carry).

Appendix 3 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Asset Services. The forward forecast rates, are in line with the Council's forward budgeted borrowing projections that have been incorporated into previous Medium Term Financial Strategy reports, which mitigates any pressure on the medium term financial strategy from increased loan charges.

Investments

In accordance with the Code, it is the Council's priority to ensure security of capital, then liquidity, and finally to obtain an appropriate level of return which is consistent with the Council's risk appetite.

As shown by the interest rate forecasts in Appendix 3, it is now impossible to earn the level of interest rates commonly seen in previous decades as most investment rates are barely above zero now that Bank Rate is at 0.10%,. Furthermore, 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.

£70.000 million of the Council's investments are held in fixed term deposits with other Local Authorities (see table 4 below) that mature across the current and forthcoming 3 financial years, with a further £14.985 million in bank notice accounts (with the notice period equating to 180 days).

Day to day liquidity to meet cashflow requirements are sourced from the Council's three Money Market Funds and call bank account with the Royal Bank of Scotland, which all operate on an instant access basis. Interest rates receivable from these are currently between 0.01% and 0.06%, in line with the low Bank of England Base Rate.

The Chief Officer Corporate Solutions confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2020/21.

Given the current low interest rate environment, it is proposed that Council officers, in conjunction with Link Asset Services, continue to review the range of investment options available to the Council within its stated investment policy in the Treasury Management & Annual Investment Strategy approved by Council on 11 February 2020 in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

An updated list of approved Countries for Investments as at 30 September 2020 is included as Appendix 4.

<u>Expected Loan & Investment Portfolio at 31 March 2021</u>

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2020 is shown in Tables 3 and 4 below:-

Table 3: Council's forecast Loan Portfolio at 31 March 2021

| **Loan Type** | **31 March 2021** | |
|---|---|---|
| | **Principal Outstanding £000's** | **Weighted Average Rate** |
| PWLB Annuity | 597 | 8.90% |
| PWLB Maturity | 235,424 | 3.28% |
| LOBO | 20,000 | 4.51% |
| Market Loans | 18,191 | 2.68% |
| Temporary Market Loans | 0 | n/a |
| Other Loans | 583 | 0.00% |
| **Total Loans** | **274,795** | **3.34%** |
| | | |
| **Underlying Borrowing Requirement** | **313,640** | |
| **Internal Borrowing** | **38,845** | |

Table 4: Council's forecast Investment Portfolio at 31 March 2021

| Investment Type | 31 March 2021 | |
|---|---|---|
| | **Principal Outstanding £000's** | **Weighted Average Rate** |
| Money Market Funds | 19,718 | 0.02% |
| Bank Call Accounts | 0 | n/a |
| Bank Notice Accounts | 14,985 | 0.58% |
| Bank Fixed Term Deposit Accounts | 0 | n/a |
| Other Local Authority Fixed Term Deposits | 70,000 | 1.46% |
| **Total Investments** | **104,703** | **1.06%** |

## 7 Prudential Indicators 2020/21

The following prudential indicators have been refreshed from those reported to Council on 11 February 2020 in the original Treasury Management and Annual Investment Strategy Statement 2020/21, based on the actual outturn for 2019/20 and the Council's Capital Plans for 2020/21 to 2024/25, and are shown in Table 5:-

Table 5: Prudential Indicators 2020/21 – Mid Year Update

| **Indicator** | **2020/21 Original Estimate £000's** | **2020/21 Current Position £000's** | **2020/21 Revised Estimate £000's** |
|---|---|---|---|
| 2020/21 Capital Expenditure | 144,893 | 13,618 | 63,782 |
| 2020/21 Required Borrowing | 88,432 | 8,055 | 38,309 |
| 2020/21 Underlying Borrowing Requirement* | 387,918 | 288,299 | 313,640 |
| 2020/21 Gross External Borrowing | 346,660 | 283,555 | 274,795 |
| | | | |
| Operational Boundary – Borrowing | 387,918 | 313,640 | 313,640 |
| Authorised Limit – Borrowing | 551,806 | 551,806 | 647,284 |
| | | | |
| 2020/21 Capital Financing Requirement** | 468,277 | 373,633 | 398,975 |

** Excludes "On balance sheet" PPP schemes.*
*** Includes "On balance sheet" PPP schemes.*

The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's two PPP contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements. It is recommended that this is increased to £647.284 million, reflecting the current Capital Plans.

## 8 Other Treasury related issues

Loans Fund Review

A review of Loans Fund advances was completed during the first half of the financial year. This review examined in detail the alignment of the period over which the Loans Fund advances made to fund capital expenditure were in line with the expected useful life of the assets they financed. This work identified that the period over which loans fund advances were being made was shorter than the expected life of assets, which meant that the financing charge made to the revenue account did not match the economic consumption of those assets.

Accordingly the Loans Fund review concluded that it was appropriate to extend the period over which loans fund advances are repaid. This in turn results in an in-year adjustment to the current and future years' loans fund charges to the revenue account and also a one off prior year adjustment of £8.250 million.

The 2020/21 in-year adjustment to loan charges of £0.950 million was reported to Council on 17 November 2020 in the Financial Monitoring 2020/21 General Fund Revenue report, and the in-year adjustment for the next two financial years is reflected in the corporate solution to the draft 2021/22 and 2022/23 budget which has been endorsed by Business Transformation Steering Group. This corporate solution to the next two years' budget also utilises £7.400 million of the prior year adjustment.

PWLB Consultation

The Government's consultation on the future lending terms of the Public Works Loans Board was opened on 2 March 2020 and closed on 31 July 2020, having been extended from its original deadline of 4 June 2020 due to the coronavirus pandemic.

As part of this consultation, the government cut the interest rate on new loans for social housing (HRA Certainty Rate) by 100 basis points, to gilts + 80 basis points. The Council utilised this reduction in borrowing rate to finance HRA capital expenditure through the drawing of a long term loan from PWLB on 28 April 2020 as noted in Section 5.

It is possible that the PWLB's non-HRA Certainty Rate (currently gilts + 180 basis points) will be subject to revision downwards after the conclusion of the PWLB consultation; however, the quantum and timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

## 9 Summary

Treasury Management activity during the year to 30 September 2020 has been effective in minimising borrowing costs and maximising investment income within the parameters set by the strategy for the year. The conclusion of the Loans Fund review ensures that the cost of financing assets is charged to the revenue account in line with the useful lives of those assets. The review also supports the delivery of a corporate solution to addressing the projected budget gaps for financial years 2021/22 and 2022/23.

No further long-term borrowing is forecast for the remainder of 2020/21, reflective of the borrowing undertaken in the first half of the year and the General Services and HRA capital plans reported to Council on 17 November 2020.

Consideration will continue to be given to whether borrowing now (for capital expenditure beyond 2020/21) to secure historically low rates offers value compared with forward interest rate projections, and/or whether any forward borrowing opportunities offer value (this would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher, eliminating the majority of the cost of carry).

The investment climate remains challenging given the extremely low interest rate environment and economic climate. Officers will continue to review the investment opportunities available to the Council.

The Prudential Indicators have been updated to reflect current capital expenditure and income projections.

## 10 Report Implications

### 10.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, was reported in the quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2020/21 – General Fund Revenue report that was presented to Council on 17 November 2020.

### 10.2 Digital

None.

### 10.3 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

### 10.4 Ensuring Equalities

There are no equalities issues arising directly from this report.

### 10.5 Additional Report Implications

See Appendix A.

## Appendix A: Report Implications

### A.1 Key Priorities within the Single Midlothian Plan

Not applicable.

### A.2 Key Drivers for Change

### A.3 Key Delivery Streams

Themes addressed in this report:

- ☐ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☐ Efficient and Modern
- ☐ Innovative and Ambitious
- ☐ None of the above

### A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

### A.5 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Asset Services, the Council’s appointed Treasury Consultants.

### A.6 Impact on Performance and Outcome

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council’s capital expenditure is sustainable in revenue terms.

### A.7 Adopting a Preventative Approach

Not applicable.

### A.8 Supporting Sustainable Development

Not applicable.

**Background Papers:**

Appendix 1: Economic Update for first part of 2020/21 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2020 to 30 September 2020
Appendix 3: Link Asset Services Interest Rate Forecasts
Appendix 4: Approved Countries for Investments as at 30 September 2020

## Appendix 1: Economic Update for first part of 2020/21 financial year

### UK

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 quashed 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. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery.

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, or negative, 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 the continuing outbreaks of the virus across the US leading to local 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 the majority of 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**

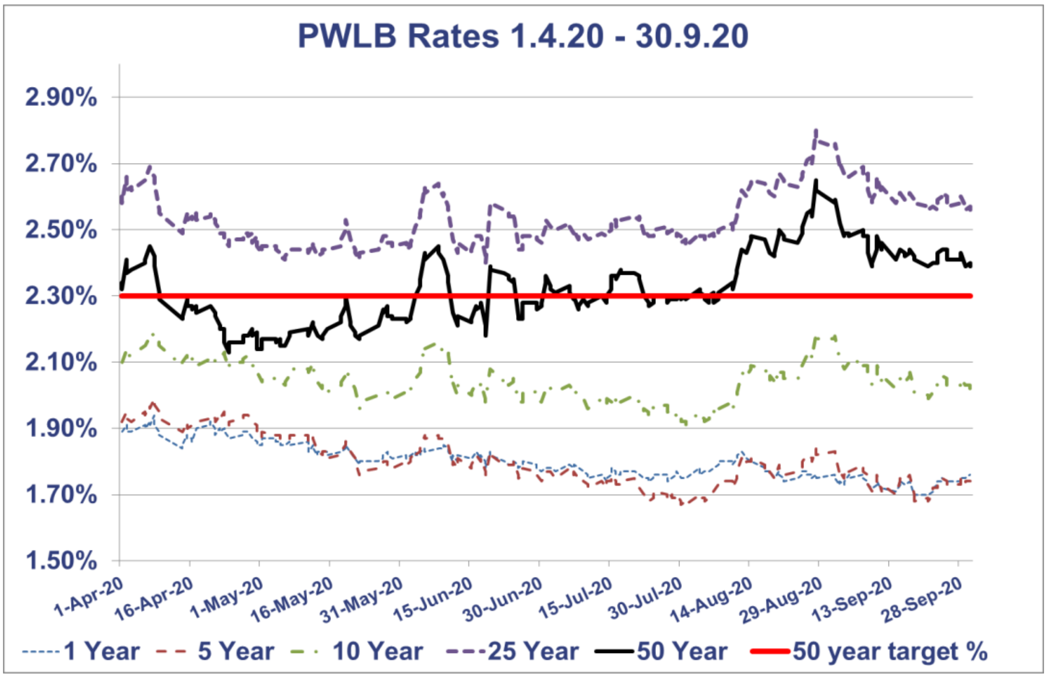
Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

## Appendix 2: PWLB Borrowing Rates 1 April 2020 to 30 September 2020

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

### PWLB certainty rates 1 April 2020 to 30th September 2020

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---|---|---|---|---|---|
| Low | 1.70% | 1.67% | 1.91% | 2.40% | 2.13% |
| Date | 18/09/2020 | 30/07/2020 | 31/07/2020 | 18/06/2020 | 24/04/2020 |
| High | 1.94% | 1.99% | 2.19% | 2.80% | 2.65% |
| Date | 08/04/2020 | 08/04/2020 | 08/04/2020 | 28/08/2020 | 28/08/2020 |
| Average | 1.80% | 1.80% | 2.04% | 2.54% | 2.33% |



## Appendix 3: Link Asset Services Interest Rate Forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

| 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 and November meetings), 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.

**PWLB Rates / Gilt Yields**

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 non-HRA Standard Rate** is gilt plus 200 basis points (G+200bps)
- ***PWLB non-HRA 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)*

** Those in italics are those currently applicable/available to Midlothian Council.*

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 non-HRA 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.

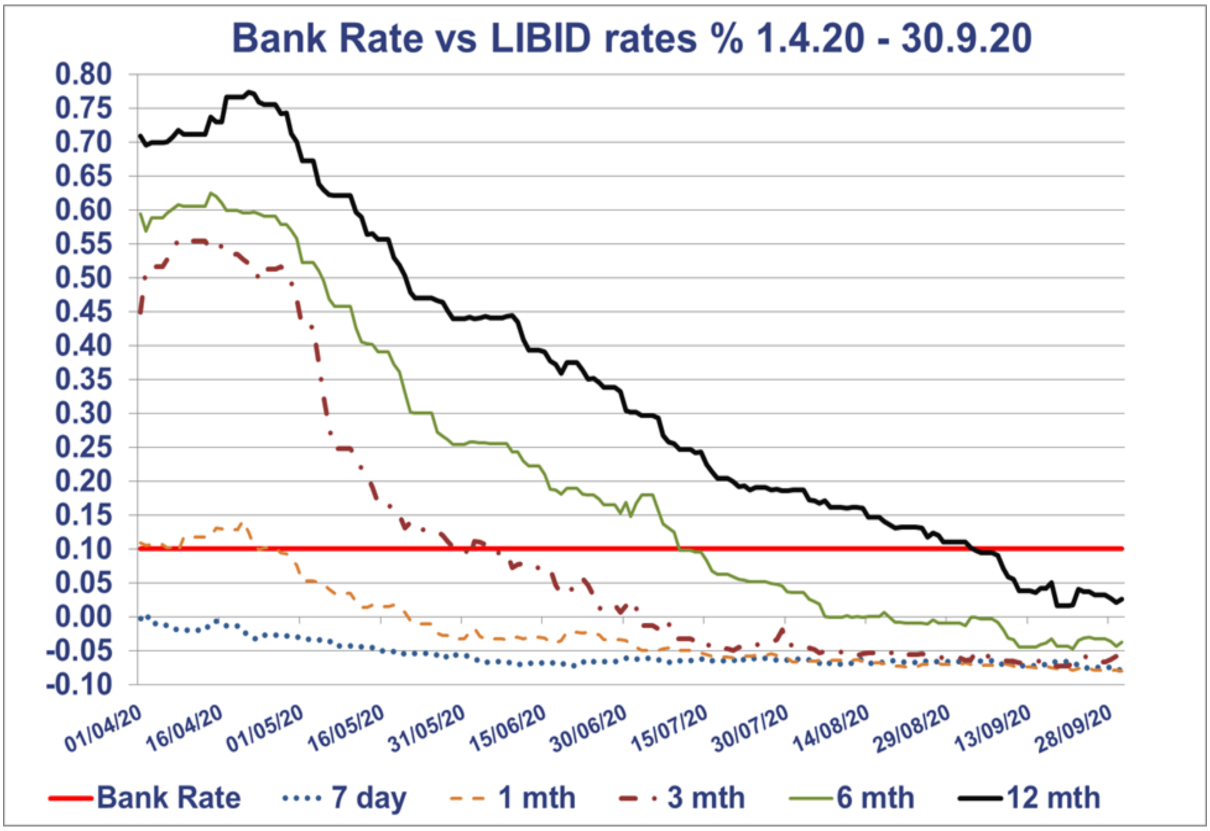
**Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**

- **UK** - second nationwide wave of virus infections and local and national lockdowns;
- **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 impact of the Presidential election in 2020, including 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.

**Interest Rates**




<u>Negative investment rates</u>
While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods.  As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks.  In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid crisis; this has caused some local authorities to have sudden large increases in investment balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have suggested that they might resort to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a glut of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Creditworthiness
Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks made provisions for expected credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on actual levels of credit losses. (Quarterly performance is normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". They stated that in their 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%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades.

The Council's Treasury Advisers, Link, have conducted some stress testing on their credit methodology based list of counterparties supplied to clients, to test for the results of a 1 notch downgrade to all Long Term Ratings from all agencies. Under such a scenario, only Commerzbank, Norddeutsche Landesbank, NatWest Markets Plc (non-ring-fenced entity), Leeds, Skipton and Yorkshire Building Societies moved from Green to No Colour. While there are a further 17 drops in other entities' suggested durations, in these instances, these entities still remain potentially available for use.

CDS prices
Although CDS prices, which are market indicators of credit risk, for UK banks spiked upwards at the end of March / early April due to the liquidity crisis throughout financial markets, CDS prices have returned to more average levels since then, although they are still elevated compared to end-February. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

## Appendix 4: Approved Countries for Investments as at 30 September 2020

### AAA
- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

### AA+
- Canada
- Finland
- U.S.A.

### AA
- Abu Dhabi (UAE)
- France

### AA-
- Belgium
- Hong Kong
- Qatar
- U.K.