Midlothian Council
Tuesday 12 November 2019

Treasury Management Mid-Year Review Report 2019/20

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2019/20, the forecast activity for the second half of 2019/20, an update to the Treasury and Prudential Indicators for 2019/20, and the link across to the Council's Capital Investment Strategy.

2 Background

Treasury management

The Prudential Code recommends that the main Treasury Management reports are presented to Audit Committee in advance of consideration by Council. However as the next scheduled Audit Committee meeting is on 3 December 2019 this mid-year report is being presented to Council today in advance of consideration by Audit Committee to both avoid delay in its consideration and to allow it to be considered at the same as the second quarter financial reports. Any comments arising from Audit Committee consideration of the report on 3 December 2019 will be reported to Council either by way of a separate report or as part of the minutes of Audit Committee.

In addition, Treasury Management training has been arranged for elected members on the 5th November 2019, with the training being run by the Council's treasury management advisers, Link Asset Services. In advance of this meeting, members will have a copy of this mid-year report, alongside the capital plan monitoring reports and financial monitoring – general fund revenue report, which will provide Members with the most up to date position on the Council's treasury management position, capital and revenue budgetary position in advance of the training workshop.

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 12 February 2019, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2019/20.

3 Economic update for first half of 2019/20

The key points from economic activity in the first half of 2019/20 are as follows:-

- Borrowing rates dropped to historically low levels, with longer term Public Works Loan Board (PWLB) rates almost halving to drop significantly below 2.00% from August 2019;
- Consumer Price Inflation has hovered around the Bank of England's target of 2.00% during 2019, falling to 1.7% in August. It is likely to remain close to 2% over the next two years; however this is heavily dependent on the outcome of the Brexit negotiations;
- The Bank of England Base Rate has remained unchanged at 0.75% throughout the first half of the year. With so many variables over the coming months in relation to the outcome of Brexit and the likely general election, interest rate forecasts are subject to material change as the situation evolves;
- The expectation is that both new fixed term and variable rate investment opportunities and temporary loan rates will follow any movements in Base Rate.

An economic update for the first part of the 2019/20 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2.

4. Treasury Activity during first half of 2019/20

The main points arising from treasury activity in the year to 30 September 2019 were:-

- Taking advantage of the historically low PWLB rates in the latter part of the first half of the year, two new long term loans were sourced from PWLB on 25 September 2019 as follows:-
    - £10 million maturity loan with a 20 year tenor at a fixed interest rate of 1.76%;
    - £10 million maturity loan with a 50 year tenor at a fixed interest rate of 1.68%;
- Long term borrowing of £0.447 million matured, this being £0.316 million of Market Loans, £0.113 million of Salix loans and £0.018 million PWLB Annuities;
- The level of short term borrowing has been temporarily reduced to nil as a result of Capital Grant and Developer Contribution receipts during the summer;
- Two short term investments beyond a duration of 1 day were placed:-
    - £10 million fixed term deposit for 1 year, placed with Bank of Scotland on 26 June 2019, earning an interest rate return of 1.25%. In addition, the existing £20 million with Bank of Scotland on 175 days' notice at an interest rate of 1.13% was converted to a fixed term deposit for 1 year, also earning an interest rate return of 1.25%;
    - £10 million fixed term deposit for 18 months with Rushmoor Borough Council, earning an interest rate return of 1.15%;
- The average interest rate earned on external investments was 1.16%, exceeding the benchmark rate of 0.73%.

The Council's loan and investment portfolio as at 30 September 2019 is shown in tables 1 and 2 below (position at 31 March 2019 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2019 and 30 September 2019.

Loan Type	**31 March 2019**		**30 September 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	674	8.90%	656	8.90%
PWLB Maturity	187,224	3.73%	207,224	3.37%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	19,464	2.68%	19,149	2.68%
Temporary Market Loans	9,000	0.78%	0	n/a
Other Loans	916	0.00%	803	0.00%
Total Loans	**237,279**	**3.60%**	**247,832**	**3.42%**
Underlying Borrowing Requirement*	**274,582**		**283,772**	
Internal Borrowing	**37,303**		**35,940**	

* *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 2019 and 30 September 2019

Investment Type	**31 March 2019**		**30 September 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	9,767	0.78%	23,012	0.73%
Bank Notice Accounts	49,985	1.00%	44,985	1.20%
Deposits with other Local Authorities	15,000	1.70%	25,000	1.48%
Total Investments	**74,752**	**1.11%**	**74,286**	**1.16%**

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.

5. Expected Treasury Activity during second half of 2019/20

Borrowing

Long term borrowing of £8.823 million will mature in the second half of 2019/20, this being £8.400 million maturity loan with PWLB, £0.317 million of Market Loans, £0.087 million of Salix loans and £0.019 million PWLB Annuities;

The £8.400 million maturity loan with PWLB which matures on 14 December 2019 has already been refinanced with new longer term PWLB borrowing as outlined in Section 4 above.

On 9 October 2019 the UK's Debt Management Office announced that with immediate effect, all long term loan rates available to Local Authorities from the Public Works Loans Board (PWLB) would be increased by 100bps (1.00%) on top of the existing loan terms. This now means that rates are now Gilts+180bps for all Local Authorities that qualify for the Certainty Rate, rather than the previous Gilts+80bps.

At the same time, the Government has legislated to increase its lending limit for PWLB loans from £85 billion to £95 billion to ensure that PWLB loans can continue to be offered to Local Authorities. A copy of this announcement is attached as Appendix 3.

This now places PWLB rates either level, or potentially higher, than other loan rates available in the marketplace. The Council, along with its Treasury advisers Link Asset Services, will monitor how the marketplace as a whole reacts to this change in PWLB margins and what products other private sector providers may be able to offer the Council.

The Council borrowed two £10 million maturity loans from PWLB in September 2019, in advance of the increase in rates outlined above to finance the Council's capital plans. Had the Council delayed the decision to borrow in September 2019 to a date beyond 9 October 2019, the impact on the Council's loan charges would have been an extra £200,000 per annum (£20,000,000 loan x 1% increase in interest rate). Based on the two loan tenors of 20 years and 50 years, this would have cost the Council £7 million more in interest costs over the lives of the loans.

It is expected that no further long-term borrowing will be sourced in the second half of 2019/20, and that temporary borrowing will be sourced to finance capital expenditure, taking advantage of the rates in this market sitting at less than the Bank of England Base Rate.

However, given the current forecasts of capital expenditure, as presented to Council elsewhere on today's agenda, and any revisions to these forecasts, for 2019/20 and beyond as previously reported to Council, consideration will be given to borrowing now (for capital expenditure beyond 2019/20) 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 4 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Asset Services. The forward forescast rates, which incorporate the increase to the PWLB rates as outlined above, 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 noted in Section 3 and detailed in Appendix 1, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line, or below, with the current 0.75% Bank Rate. The evolving position with regard to Brexit prompts a low risk and short-term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

£25.000 million of the Council's investments are held in fixed term deposits with other Local Authorities that mature in March 2020 and January 2021, £30.000 million in a fixed term bank deposit account that matures in June 2020, and £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, which operate on an instant access basis. Interest rates receivable from these funds fluctuate on a daily basis and broadly track the Bank of England Base Rate (with a slight lag following any base rate drop/increase due to the slightly longer tenor duration of these funds). As of 30 September, the interest rates across the three funds lay between 0.71% and 0.73%.

The Head of Finance & Integrated Service Support confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2019/20.

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 12 February 2019 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 2019 is included as Appendix 5).

Expected Loan & Investment Portfolio at 31 March 2020

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2020 is shown in Tables 7 and 8 below:-

Table 7: Council's forecast Loan Portfolio at 31 March 2020

Loan Type	**31 March 2020**	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	637	8.90%
PWLB Maturity	207,224	3.37%
LOBO	20,000	4.51%
Market Loans	18,831	2.68%
Temporary Market Loans	20,000	0.75%
Other Loans	716	0.00%
Total Loans	**267,408**	**3.21%**
Underlying Borrowing Requirement	**314,618**	
Internal Borrowing	**47,210**	

Table 8: Council's forecast Investment Portfolio at 31 March 2020

Investment Type	**31 March 2020**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	10,000	0.70%
Bank Notice Accounts	14,985	1.10%
Bank Fixed Term Deposit Accounts	30,000	1.25%
Other Local Authority Fixed Term Deposits	25,000	1.48%
Total Investments	**79,985**	**1.23%**

6. Prudential Indicators 2019/20

The following prudential indicators have been refreshed from those reported to Council on 12 February 2019 in the original Treasury Management and Annual Investment Strategy Statement 2019/20, based on the actual outturn for 2018/19 and the Council's Capital Plans for 2019/20 to 2022/23, and are shown in Table 9 (see also Appendix 6):-

Table 9: Prudential Indicators 2019/20 – Mid Year Update

Indicator	2019/20 Original Estimate £000's	2019/20 Current Position £000's	2019/20 Revised Estimate £000's
2019/20 Capital Expenditure	99,892	19,619	78,789
2019/20 Required Borrowing	61,093	9,190	43,613
2019/20 Underlying Borrowing Requirement*	346,056	283,772	318,195
2019/20 Gross External Borrowing	287,869	247,832	256,431
Operational Boundary – Borrowing	352,977	289,447	324,559
Authorised Limit – Borrowing	524,349	524,349	524,349
2019/20 Capital Financing Requirement**	428,888	366,604	401,027

** 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. This was recommended to be £524.349 million in the Treasury Strategy report presented to Council on 12 February 2019 and subsequently agreed by Council.

7 Report Implications

7.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, is reported in quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2019/20 – General Fund Revenue report that will be presented to Council on 12 November 2019.

7.2 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.

7.3 Single Midlothian Plan and Business Transformation

Themes addresses in this report:-

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

7.4 Impact on Performance and Outcomes

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.

7.5 Adopting a Preventative Approach

The proposals in this report do not directly impact on the adoption of a preventative approach.

7.6 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.

7.7 Ensuring Equalities

There are no equality issues arising from this report.

7.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

7.9 Digital Issues

There are no Digital Services implications arising from this report.

8 Summary

Treasury Management activity during the year to 30 September 2019 has been effective in minimising borrowing costs and maximising investment income within the parameters set by the strategy for the year.

No further long-term borrowing is forecast for the remainder of 2019/20, reflective of the borrowing undertaken in the first half of the year and the General Services and HRA capital plans reported elsewhere on today's agenda. Consideration will continue to be given to whether borrowing now (for capital expenditure beyond 2019/20) 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 low interest rate environment and creditworthiness concerns. 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.

9 Recommendations

It is recommended that Council:-

a) Note that this Treasury Management Mid-Year Report 2019/20 will be scrutinised by the Audit Committee at its next meeting on 3 December 2019 and that any comments arising from the Audit Committee's consideration of the report will be reported to Council either by way of a separate report or as part of the minutes of Audit Committee in order to fulfil its role on scrutiny of treasury management.
Subject to the above:
b) Note the report and the treasury activity undertaken in the period to 30 September 2019, as outlined in Section 4;
c) Note the forecast activity during the second-half of the year as outlined in Section 5;
d) Approve the revisions to the Prudential Indicators in Section 6 of this report.

18 October 2019

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Appendices

Appendix 1: Economic Update for first part of 2019/20 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2019 to 30 September 2019
Appendix 3: PWLB Borrowing Rates Announcement
Appendix 4: Link Asset Services Interest Rate Forecasts
Appendix 5: Approved Countries for Investments as at 30 September 2019
Appendix 6: Prudential Indicators Detail

Appendix 1: Economic Update for first part of 2019/20 financial year

UK

This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there is no deal by 31 October. MPs also voted down holding a general election before 31 October, though one is likely before the end of 2019. So far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing, (first week in October), the whole Brexit situation is highly fluid and could change radically by the day. Given these circumstances and the likelihood of an imminent general election, any interest rate forecasts are subject to material change as the situation evolves. If the UK does soon achieve a deal on Brexit agreed with the EU, including some additional clarification wording on the Irish border backstop, then it is possible that growth could recover relatively quickly. The MPC could then need to address the issue of whether to raise Bank Rate when there is very little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in government departments and services annual expenditure budgets and expenditure on infrastructure projects, to boost the economy.

The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market**, despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than

115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

In the **political arena**, if there is a general election soon, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA

President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc). It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

Eurozone

Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels “at least through the end of 2019”, but that was of little help to boosting growth in the near term. Consequently, it announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank’s eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy. On the political front, Austria, Spain and Italy are in the throes of forming coalition governments with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

China

Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress also still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. The trade war with the US does not appear currently to have had a significant effect on GDP growth as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

Japan

Japan has been struggling 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.

World Growth

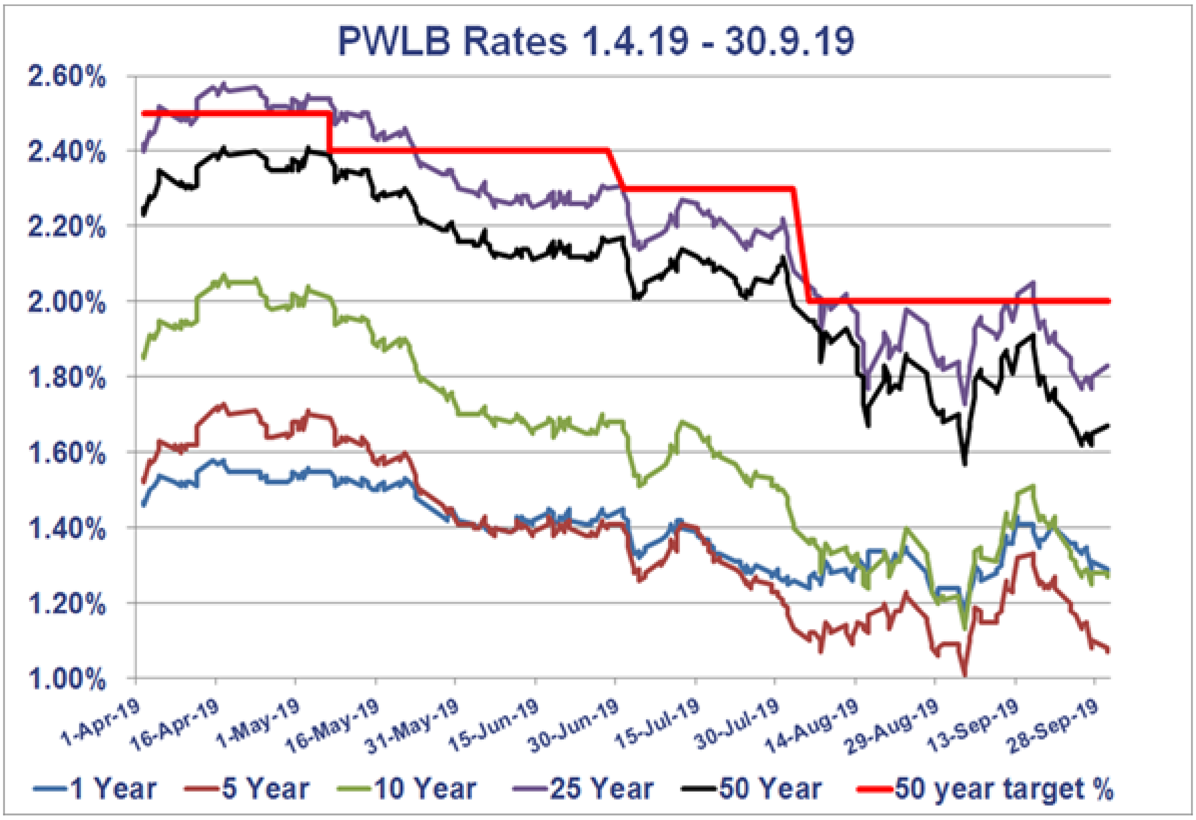
The trade war between the US and China is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns are focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US), and there are concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been sub 50 which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

Appendix 2: PWLB Borrowing Rates 1 April 2019 to 30 September 2019

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 2019 to 30th September 2019

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.01%	1.13%	1.73%	1.57%
Date	03/09/2019	03/09/2019	03/09/2019	03/09/2019	03/09/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.40%	1.37%	1.62%	2.20%	2.07%



Appendix 3: PWLB Borrowing Rates Announcement

HM Treasury

One Horse Guards Road
London
SW1A 2HQ

T 020 7270 5000
E certainty.rate@hmtreasury.gov.uk

www.gov.uk/hm-treasury

Dear Chief Finance Officer,

9 October 2019

Public Works Loan Board (PWLB) interest rates

1. The Government recognises that the freedoms for local authorities to borrow under the Prudential Framework are fundamental to supporting local capital strategies and authorities' organisational objectives, including regeneration, supporting local growth and service delivery. The PWLB supports this activity by on-lending Government borrowing from the capital markets to local authorities to deliver capital investment.

2. The maximum net amount of PWLB loans that can be outstanding at any time is subject to a statutory limit. In order to ensure that lending continues to be available for local authorities that need it, the Government has legislated to increase the lending limit from £85bn to £95bn.

3. PWLB lending is offered at a fixed margin above the Government's cost of borrowing, as measured by gilt yields. The Treasury raised the margin over gilts to 100bps (one percentage point) in 2010, to better reflect the availability of capital finance, and lowered it to 80bps over gilts in 2013 for qualifying authorities.

4. Some local authorities have substantially increased their use of the PWLB in recent months, as the cost of borrowing has fallen to record lows. HM Treasury is therefore restoring interest rates to levels available in 2018, by increasing the margin that applies to new loans from the PWLB by 100bps (one percentage point) on top of usual lending terms.

5. This restoration of normal PWLB lending rates will apply to all new loans with immediate effect. The Government will monitor the impact of this change and keep rates policy under review.

6. As always, the Government will continue to work with individual authorities on a case-by-case basis if they have concerns over their financial position.

Signed,

Local Government & Reform Team, HM Treasury

Appendix 4: Link Asset Services Interest Rate Forecasts

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

Link Asset Services Interest Rate View	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	2.20	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.10	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.00	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit at some point in time. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth. The September MPC meeting sounded even more concern about world growth and the effect that prolonged Brexit uncertainty is likely to have on growth.

Bond yields / PWLB rates. There has been much speculation recently that we are currently in a bond market bubble. However, given the context that there are heightened expectations that the US could be heading for a recession, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty 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. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten 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. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

What we have seen during the last half year is a near halving of longer term PWLB rates to completely unprecedented historic low levels. There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but due to a correlation between US treasuries and UK gilts, which at various times has been strong but at other times weaker, in the UK. However, forecasting the timing of this and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt fuelled boom which now makes it harder for economies to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop. (A doom loop would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc.). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash. There has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for eleven years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could, therefore, over or under-do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.

- **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**. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new unlikely alliance of two very different parties will endure.
- Weak capitalisation of some **European banks**, particularly Italian banks.
- **German minority government**. 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. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health.
- **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy**, **Austria**, **The Czech Republic** and **Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks**, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if agreement was reached all round that removed all threats of economic and political 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.
- **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Appendix 5: Approved Countries for Investments as at 30 September 2019

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- Hong Kong
- France
- U.K.

AA-

- Belgium
- Qatar

Appendix 6: Prudential Indicators Detail

Prudential Indicator for Capital Expenditure

The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the budget:-

Capital Expenditure by Service	**2019/20 Original Estimate £000's**	**Current Position £000's**	**2019/20 Revised Estimate £000's**
Resources	16,273	1,970	12,711
Education, Community & Economy	25,203	8,628	29,742
Health & Social Care	4,605	546	1,250
Council Transformation	2	2	2
Provision for return of contingencies	-710	0	-417
HRA	54,519	8,473	35,501
Total	**99,892**	**19,619**	**78,789**

Forecast levels of capital expenditure on:-

- Resources has decreased by £3.562 million compared to budget, due to rephasing of projects from 2019/20 to 2020/21, in particular the rephasing of expenditure for the Vehicle & Plant Replacement programme, Destination Hillend, EWiM Phase III and the block Property Upgrades projects;
- Education, Community & Economy has increased by £4.539 million, due to the construction of Hopefield, Cuiken and Lawfield Primary Schools, and the construction of the Rosewell Development Trust hub, running as scheduled compared to the planning assumption that these projects would have an element of delay, and the inclusion of new projects at Woodburn, Tynewater and Burnbrae Primary Schools;
- Health & Social Care has decreased by £3.355 million reflecting the delay in the Highbank Intermediate Care Provisioning project as a result of the decision to delay the commencement of construction works until St. Mary's Primary School has been decanted to the new Hopefield Primary School;
- HRA has decreased by £19.018 million to reflect the rephasing of the Phase II to IV programmes.

Prudential Indicator for the Financing of the Capital Programme & Borrowing

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (principal repayments). This direct borrowing need is also supplemented by maturing debt and other treasury requirements.

Capital Financing	**2019/20 Original Estimate £000's**	**Current Position £000's**	**2019/20 Revised Estimate £000's**
Total Capital Expenditure	**99,892**	**19,628**	**78,789**
Capital Grants	18,554	6,197	22,559
Capital Receipts	0	15	15
Capital Reserves	1,900	2,437	2,437
Developer/Other Contributions	10,104	2,321	10,164
Total Financing	**30,558**	**10,970**	**35,176**
Borrowing Required	**69,334**	**8,658**	**43,613**

Total expected financing has increased from £30.558 million to £35.176 million.