Treasury Management Mid-Year Review Report 2018/19

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 2018/19, the forecast activity for the second half of 2018/19, an update to the Treasury and Prudential Indicators for 2018/19, and the link across to the Council's Capital Investment Strategy.

2 Background

Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy that is intended to provide the following:-

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

A report setting out the draft Capital Investment Strategy was presented to Council on 26 June 2018 with an updated Capital Investment Strategy elsewhere on today's agenda for adoption.

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 schedule meeting of Audit Committee is not until 11 December 2018 . To avoid unnecessary delay in members' consideration of the Mid-Year report it has been brought to Council in the first instance. In future, the revised schedule of meeting dates for Audit Committee provides for the key treasury reports to go to Audit Committee before being presented to Council.

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 13 February 2018, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2018/19.

3 Economic update for first half of 2018/19

The key points from economic activity in the first half of 2018/19 are as follows:-

- Borrowing rates remain at historically low levels, with long term Public Works Loan Board (PWLB) rates fluctuating between the 2.25% to 2.83% mark throughout the first 6 months of the financial year;
- Consumer Price Inflation rose from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years;
- The Monetary Policy Committee (MPC), on 2nd August 2018, voted unanimously (9-0) to increase the Bank of England Base Rate from 0.50% to 0.75%. The MPC has indicated that the Base Rate will need to be in the region of 1.5% by March 2021 for inflation to stay on track;
- The expectation is that both new fixed term and variable rate investment opportunities and temporary loan rates will follow any increases in Base Rate.

An economic update for the first part of the 2018/19 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 2018/19

The main points arising from treasury activity in the year to 30 September 2018 were:-

- No long-term borrowing was sourced;
- Long term borrowing of £0.226 million matured, this being £0.179 million of Market Loans, £0.031 million of Salix loans and £0.016 million PWLB Annuities;
- The level of short term borrowing has been significantly reduced;
- No short term investments beyond a duration of 1 day were placed;
- The average interest rate earned on external investments was 0.78%, exceeding the benchmark rate of 0.71%.

The Council's loan and investment portfolio as at 30 September 2018 is shown in tables 1 and 2 below (position at 31 March 2018 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2018 and 30 September 2018

Loan Type	**31 March 2018**		**30 September 2018**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	708	8.90%	692	8.90%
PWLB Maturity	197,224	3.72%	197,224	3.72%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	9,821	2.63%	9,643	2.63%
Temporary Market Loans	13,000	0.58%	3,000	0.57%
Other Loans	277	0.00%	234	0.00%
Total Loans	**241,031**	**3.47%**	**230,793**	**3.71%**
Underlying Borrowing Requirement*	**280,248**		**275,176**	
Internal Borrowing	**39,217**		**44,383**	

* *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 2018 and 30 September 2018

Investment Type	31 March 2018		30 September 2018	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate %
Money Market Funds	8,026	0.46%	9,301	0.69%
Bank Notice Accounts	49,985	0.73%	49,985	0.90%
Deposits with other Local Authorities	15,000	1.00%	15,000	1.00%
Total Investments	**73,011**	**0.75%**	**74,286**	**0.89%**

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 2018/19

Borrowing
Long term borrowing of £10.227 million will mature in the second half of 2018/19, this being £10.000 million maturity loan with PWLB, £0.179 million of Market Loans, £0.031 million of Salix loans and £0.017 million PWLB Annuities;

The £10.000 million maturity loan with PWLB matures on 15 November 2018. The Council has already refinanced this loan through the execution of the forward borrowing deal with Deutsche Pfandbriefbank in February 2016, at a fixed rate of 2.73%, thereby hedging against future long-term borrowing rate movements from February 2016. The £10.000 million loan from Deutsche Pfandbriefbank will be drawn on 15 November 2018, directly matched to the maturity date of the £10.000 million PWLB loan.

It is expected that a no further long-term borrowing will be sourced in the second half of 2018/19.

However, given both:-

a) the historically low interest rate environment; and
b) the current forecasts of capital expenditure, as presented to Council elsewhere on today's agenda, and any revisions to these forecasts, for 2018/19 and beyond as previously reported to Council;

consideration will be given to borrowing now (for capital expenditure beyond 2018/19) to secure historically low PWLB rates if it is determined that these 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.

Investments

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and 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 continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, 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.

£15.000 million of the Council's investments are held in fixed term deposits with other Local Authorities that mature in March 2020, and £49.985 million in bank notice accounts (with the notice period equating to broadly 6 months).

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 0.67% and 0.69%.

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 2018/19.

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 13 February 2018 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.

Expected Loan & Investment Portfolio at 31 March 2019

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2019 is shown in Tables 7 and 8 below:-

Table 7: Council's forecast Loan Portfolio at 31 March 2019

Loan Type	**31 March 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	674	8.90%
PWLB Maturity	187,224	3.73%
LOBO	20,000	4.51%
Market Loans	19,464	2.68%
Temporary Market Loans	15,000	0.75%
Other Loans	203	0.00%
Total Loans	**242,565**	**3.54%**
Underlying Borrowing Requirement	**292,302**	
Internal Borrowing	**49,737**	

Table 8: Council's forecast Investment Portfolio at 31 March 2019

Investment Type	**31 March 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	10,000	0.80%
Bank Notice Accounts	49,985	0.90%
Other Local Authority Fixed Term Deposits	15,000	1.70%
Total Investments	**74,985**	**1.05%**

6. Prudential Indicators 2018/19

The following prudential indicators have been refreshed from those reported to Council on 13 February 2018 in the original Treasury Management and Annual Investment Strategy Statement 2018/19, based on the actual outturn for 2017/18 and the Council's Capital Plans for 2018/19 to 2021/22, and are shown in Table 9 (see also Appendix 4):-

Table 9: Prudential Indicators 2018/19 – Mid Year Update

Indicator	2018/19 Original Estimate £000's	2018/19 Current Position £000's	2018/19 Revised Estimate £000's
2018/19 Capital Expenditure	76,861	8,219	46,447
2018/19 Required Borrowing	47,740	3,265	18,587
2018/19 Underlying Borrowing Requirement*	325,196	275,176	292,302
2018/19 Gross External Borrowing	290,770	230,793	242,565
Operational Boundary – Borrowing	325,196	275,176	292,302
Authorised Limit – Borrowing	482,021	497,042	497,042
2018/19 Capital Financing Requirement**	377,429	327,409	344,535

** 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 £482.021 million in the Treasury Strategy report presented to Council on 13 February 2018 and subsequently agreed by Council.

Rather than restrict external borrowing in the remainder of 2018/19 to:-

- the expected Underlying Borrowing Requirement for this year (£292.302 million); or
- the Authorised Limit for Borrowing of £482.021 million approved by Council on 13 February 2018;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £497.042 million (as shown in the table below), if market conditions supported this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2022 remains achievable.

Table 10: Authorised Limit for Borrowing: Calculation

Indicator	2018/19 Original Estimate £000's	2018/19 Revised Estimate £000's
CFR – General Services (31 March 2021)	154,406	165,524
CFR – HRA (31 March 2021)	315,112	312,916
Forecast level of Capital Receipts & Developer Contributions 2018/19 to 2021/22	21,283	18,602
Proposed Authorised Limit – Borrowing	**482,021**	**497,042**

7 Other Treasury related issues

Performance Indicators 2017/18 – comparison with other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2017/18 have been published and once again demonstrate the continuing effectiveness of the Treasury function in maximising efficiency in Treasury Management activity, with the Council continuing to have one of the lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities, mirroring performance over the last 10 financial years. Appendix 5 outlines the loans fund rate for each Scottish Local Authority in 2017/18.

Were the internal loans fund rate to have equated to the Scottish weighted average of 3.96%, this would have generated loan charges in 2017/18 of £18.9 million. The Council's actual 2017/18 loan charges for General Services and HRA were £16.3 million, representing a cash saving (compared to the Scotland average) of £2.6 million in 2017/18.

UK Banks – Ring-fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and “riskier” activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity’s core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

IFRS9 accounting standard

This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted.

Changes in risk appetite

The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members’ attention in treasury management update reports. The Head of Finance & ISS confirms that there has been no change in the risk appetite of the Council’s Treasury Management activities in the first 6 months of 2018/19.

8 Report Implications

8.1 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 2018/19 – General Fund Revenue report that will be presented to Council on 13 November 2018.

8.2 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.

8.3 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

8.4 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.

8.5 Adopting a Preventative Approach

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

8.6 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.

8.7 Ensuring Equalities

There are no equality issues arising from this report.

8.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

8.9 Digital Issues

There are no Digital Services implications arising from this report.

9 Summary

Treasury Management activity during the year to 30 September 2018 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 2018/19, reflective of the General Services and HRA capital plans reported elsewhere on today's agenda. Consideration will continue to be given to borrowing now (for capital expenditure beyond 2018/19) to secure historically low PWLB 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.

10 Recommendations

It is recommended that Council:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2018, as outlined in Section 4;
b) Note the forecast activity during the second-half of the year as outlined in Section 5;
c) Approve the revisions to the Prudential Indicators in Section 6 of this report.

30 October 2018

Report Contact: Gary Thomson
Tel No 0131 271 3230
E mail gary.thomson@midlothian.gov.uk

Appendices

Appendix 1: Economic Update for first part of 2018/19 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2018 to 30 September 2018
Appendix 3: Link Asset Services Interest Rate Forecasts
Appendix 4: Prudential Indicators Detail
Appendix 5: Loans Fund Rate Comparison for all Scottish Local Authorities 2017/18

Appendix 1: Economic Update for first part of 2018/19 financial year

UK

The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given 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. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, 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.

USA

President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

Eurozone

Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

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.

Japan

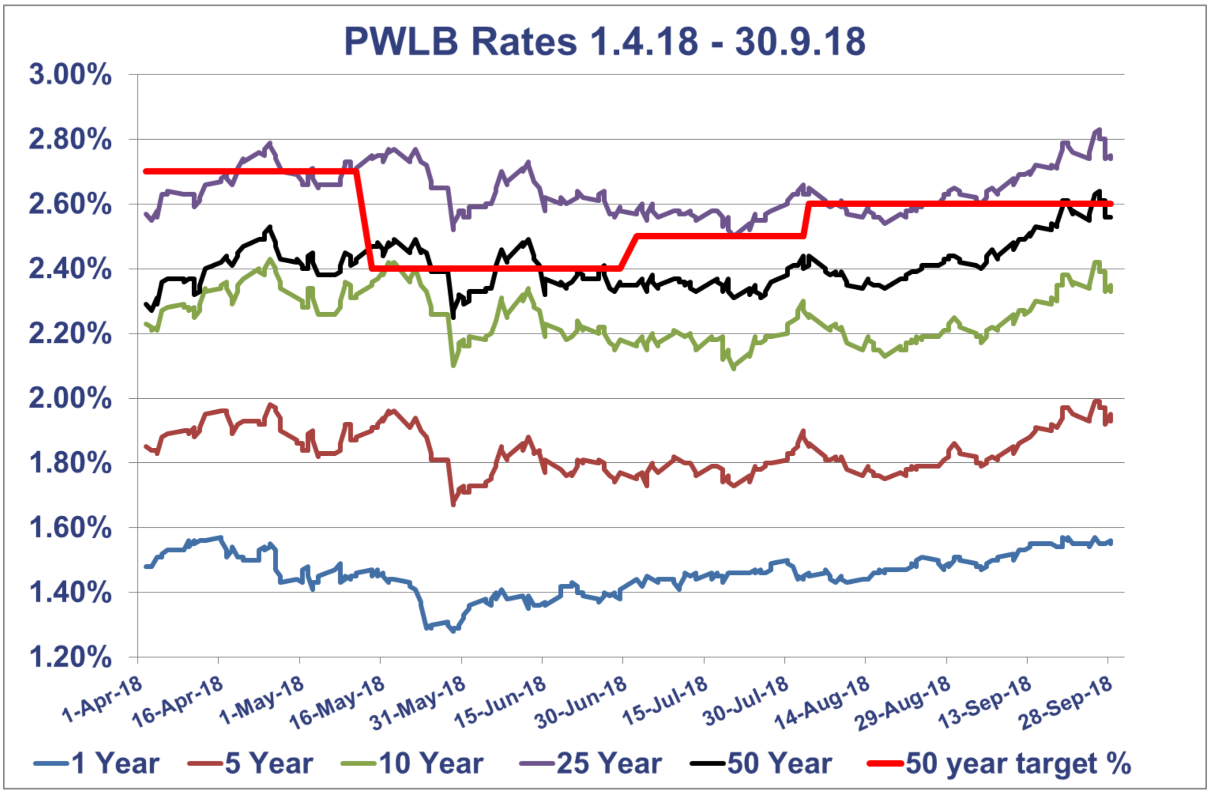
has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Appendix 2: PWLB Borrowing Rates 1 April 2018 to 30 September 2018

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 2018 to 30th September 2018

	1 Year	5 Year	10 Year	25 Year	50 Year
3.4.18	1.48%	1.84%	2.22%	2.55%	2.27%
30.9.18	1.55%	1.93%	2.33%	2.74%	2.56%
Low	1.28%	1.67%	2.09%	2.50%	2.25%
Date	01/06/2018	29/05/2018	20/07/2018	20/07/2018	29/05/2018
High	1.57%	1.99%	2.43%	2.83%	2.64%
Date	17/04/2018	25/09/2018	25/04/2018	25/09/2018	25/09/2018
Average	1.46%	1.84%	2.25%	2.64%	2.41%



Appendix 3: 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-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The balance of risks to the UK:-

- The overall balance of risks to economic growth in the UK is probably neutral;
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

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

- Bank of England monetary policy takes action too quickly 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, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising;

- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets;
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey;
- Weak capitalisation of some European banks;
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts;
- Geopolitical risks, especially 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:-

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries;
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world;
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation 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 4 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	**2018/19 Original Estimate £000's**	**Current Position £000's**	**2018/19 Revised Estimate £000's**
Resources	11,765	2,715	11,437
Education, Community & Economy	19,440	1,604	17,889
Health & Social Care	994	41	1,283
Council Transformation	3,877	-2	35
HRA	40,785	3,861	15,803
Total	**76,861**	**8,219**	**46,447**

Forecast levels of capital expenditure on:-

- Resources has decreased by £0.328 million compared to budget, due to rephasing of projects from 2018/19 to 2019/20 offset by the inclusion of approved budgets for new projects for (a) non-domestic energy efficiency and (b) Environmental projects in the Penicuik area;
- Education, Community & Economy has decreased by £1.551 million, due to rephasing of school projects from 2018/19 to 2019/20 offset by the inclusion of approved budgets for the following projects: (a) Cuiken Primary School Extension and (b) Sacred Heart Primary School Extension & Refurbishment;
- Health & Social Care has increased by £0.289 million reflecting the inclusion of an approved budget for the HIghbank Intermediate Care reprovisionin project, offset by rephasing of Assistive Technology spend from 2018/19 to 2019/20,;
- Council Transformation has decreased by £3.842 million reflecting the rephrasing of the City Deal project;
- HRA has decreased by £24.982 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	2018/19 Original Estimate £000's	Current Position £000's	2018/19 Revised Estimate £000's
Total Capital Expenditure	**76,861**	**8,219**	**46,437**
Capital Grants	17,403	3,823	16,897
Capital Receipts	0	21	21
Capital Reserves	3,900	0	0
Developer/Other Contributions	7,818	1,110	10,942
Total Financing	**29,121**	**4,954**	**27,860**
Borrowing Required	**47,740**	**3,265**	**18,587**

Total expected financing has decreased from £29.121 million to £10.942 million, reflecting:-

- Rephasing of the City Deal contribution from Capital Reserves (Capital Fund) into 2020/21
- Lower application of developer contributions to the General Services Capital Plan reflecting rephasing of expenditure from 2018/19 to 2019/20, along with rephasing from 2017/18 to 2018/19 of the contribution from Shawfair LLP towards the Shawfair Town Centre land purchase.

Appendix 5

Loans Fund Rate Comparison for all Scottish Local Authorities 2017/18

Authority	Loans Fund Rate
West Dunbartonshire	3.070%
Midlothian	3.078%
Dumfries & Galloway	3.090%
Perth & Kinross	3.247%
East Lothian	3.340%
Aberdeenshire	3.510%
Inverclyde	3.600%
Fife	3.630%
North Lanarkshire	3.660%
Falkirk	3.790%
East Dunbartonshire	3.830%
South Lanarkshire	3.850%
East Renfrewshire	3.860%
Dundee City	3.887%
Moray	4.010%
Scottish Borders	4.010%
Highland	4.010%
West Lothian	4.048%
South Ayrshire	4.090%
Argyll & Bute	4.095%
North Ayrshire	4.177%
Stirling	4.207%
Glasgow City	4.230%
Renfrewshire	4.340%
Angus	4.400%
East Ayrshire	4.700%
Aberdeen City	4.957%
Clackmannanshire	5.060%
Edinburgh City	5.120%
Scottish Average	**3.962%**

The Loans Fund Rate combines the interest paid by the Council on money borrowed, with the interest earned by the Council on money invested, along with other charges such as internal interest allowed, premiums written off and treasury-related expenses to arrive at a weighted average “loans fund rate” figure for each authority, as noted in the final column above