Midlothian Council
Tuesday 14 December 2021
Item No

Treasury Management Mid-Year Review Report 2021/22

Report by Gary Fairley, Chief Officer Corporate Solutions

Report for Consideration

1 Recommendations

Council is recommended to:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2021, 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 technical revisions to the Prudential Indicators in Section 7 of this report.

2 Purpose of Report/Executive Summary

The purpose of this report is to inform Council of the Treasury Management activity undertaken during the first half of 2021/22 and the forecast activity for the second half of 2021/22 in accordance with the Treasury Management and Annual Investment Strategy approved in February 2021. It also provides an update to the Treasury and Prudential Indicators for 2021/22.

Council should note that in accordance with the Prudential Code, a draft of the report was considered by Audit Committee on 7 December 2021, with the report approved by Audit Committee as presented.

Date: 07 December 2021
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3 Background

Governance

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 was presented to Audit Committee on 7 December 2021 for consideration prior to being presented to this meeting of Council on 14 December 2021, with the report approved by Audit Committee as presented.

Treasury management

Treasury management is defined in the Prudential Code 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."*

The main function of the treasury management service is the funding of the Council's capital investment 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 this long term borrowing requirement involves arranging long or short term loans or using cash balances, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. As part of the treasury management operations, officers ensure this cash flow is adequately planned, with available cash balances being deposited in low risk counterparties, providing adequate liquidity initially before considering optimising return on deposits.

Council, on 23 February 2021, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2021/22.

4 Economic update for first half of 2021/22

An economic update for the first part of the 2021/22 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 2021/22

The main points arising from treasury activity in the year to 30 September 2021 were:-

- Long term borrowing of £1.094 million matured, this being £0.648 million of PWLB maturities, £0.324 million of Market Loans, £0.100 million of Salix loans and £0.022 million PWLB Annuities;
- The average interest rate earned on external funds on deposit was 0.77%, exceeding the benchmark rate of 0.01%.

The Council's loan portfolio as at 30 September 2021 is shown in table 1 below (position at 31 March 2021 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2021 and 30 September 2021.

Loan Type	31 March 2021		30 September 2021	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	597	8.90%	575	8.91%
PWLB Maturity	235,424	3.28%	234,776	3.27%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	18,191	2.68%	17,867	2.68%
Temporary Market Loans	0	n/a	0	n/a
Other Loans	583	0.00%	483	0.00%
Total Loans	**274,795**	**3.34%**	**273,701**	**3.33%**
Underlying Borrowing Requirement*	**290,173**		**307,377**	
Borrowing Requirement Financed Internally (Under Borrowed)	**15,378**		**33,676**	

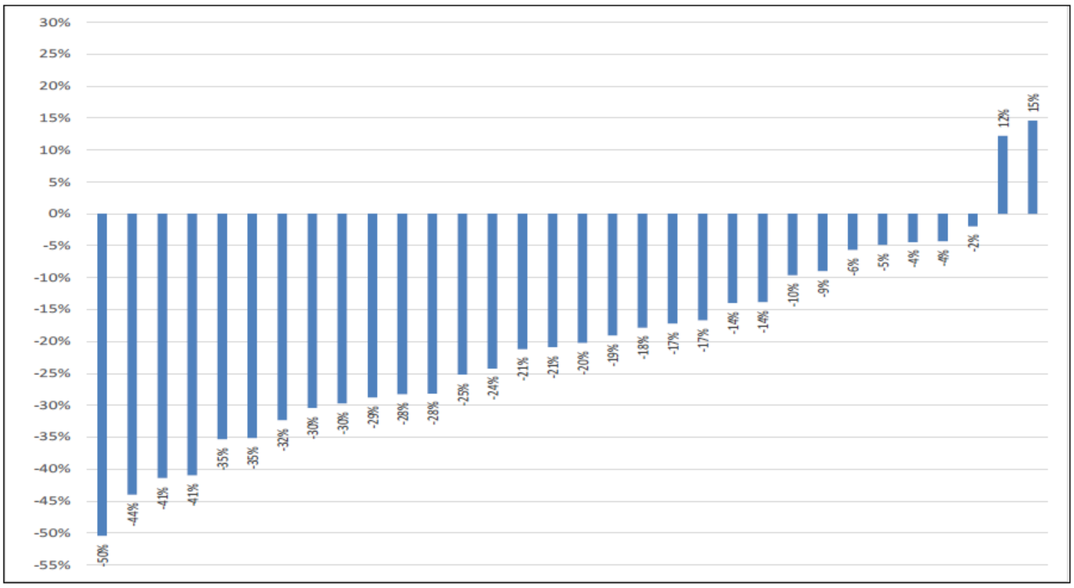
* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the "Public Private Finance" (PPP) Contract Liabilities*

At 30 September 2021 the Council was under borrowed by £33.676 million (10.96%) – this is the extent to which the Council has not financed its borrowing requirement from long term loans, but is using cash reserves and working capital to finance its borrowing requirement.

The internal borrowing position across all 32 Local Authorities in Scotland at 31 March 2021 is illustrated in the graph overleaf. It highlights that the majority of Councils are in an under borrowed position, which is reflective of the current market conditions.

Graph 1: Internal Borrowing Position across Scottish Local Authorities 31 March 2021

Internal Borrowing 2020-21 - %



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.

The Council's funds on deposit portfolio as at 30 September 2021 is shown in table 2 below (position at 31 March 2021 also shown for comparison):-

Table 2: Council's Funds on Deposit Portfolio at 31 March 2021 and 30 September 2021

Type	**31 March 2021**		**30 September 2021**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	29,818	0.01%	40,718	0.01%
Bank Call Accounts	26,470	0.01%	21,887	0.01%
Bank Notice Accounts	14,985	0.58%	14,985	0.58%
Bank Fixed Term Deposits	0	n/a	0	n/a
Deposits with other Local Authorities	60,000	1.62%	60,000	1.62%
Total Deposits	**131,273**	**0.81%**	**137,590**	**0.77%**

6 Expected Treasury Activity during second half of 2021/22

Borrowing
Long term borrowing of £0.431 million will mature in the second half of 2021/22, this being £0.325 million of Market Loans, £0.083 million of Salix loans and £0.023 million PWLB Annuities.

It is expected that any long-term borrowing required in the second half of 2021/22 will be sourced by drawing long-term PWLB loans.

Proactive Treasury Management by the Council in the last decade has placed the Council in an extremely strong refinancing position for its existing external debt portfolio, as can be noted in the table below, with only £5.466 million, or just 2.00%, of the Council's total Loan Portfolio of £273.701 million requiring refinancing over the current and forthcoming four financial years. This extremely low short-term exposure to refinancing risk puts the Council in a strong position to plan its borrowings in advance, take advantage of any dips in longer-term borrowing rates from PWLB and other sources, and maintain a low weighted average coupon rate on external debt.

Financial Year	**2021/22 Remaining £000's**	**2022/23-2025/26 £000's**	**2026/27-2030/31 £000's**	**2031/32-2035/36 £000's**	**2036/77+ £000's**
Debt Maturing	431	5,035	23,923	37,203	207,109
% of total portfolio	0.16%	1.84%	8.74%	13.59%	75.67%

Appendix 3 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Treasury Solutions Limited. 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.

Funds on Deposit
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 rates for deposit are barely above zero. Furthermore, some entities, such as the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and forecast slow and gradual rise in Bank Rate over the forecast period, deposit returns are expected to remain low.

£15.000 million of the fixed term deposits mature in March 2022 and prior to maturity officers will review the refinancing in line with the currently approved strategy to cash back reserves.

Day to day liquidity to meet cashflow requirements are sourced from the Council's three Money Market Funds and call bank accounts with the Royal Bank of Scotland and Bank of Scotland, which all operate on an instant access basis. Interest rates receivable from these are currently between 0.00% and 0.01%, reflective of the low Bank of England Base Rate. Due to Government Grant and other receipts that have been paid in advance, the balance of cash the Council is holding in Instant Access accounts is significantly higher than normal, a position that is reflected across the majority of Scottish Local Authorities. As such, the expected application/utilisation of these balances are longer in duration than normal. Council officers are reviewing the profile of the drawdown of these balances with the option to switch funds that are not required immediately from the current instant access accounts and into short-medium term deposits over a 3-6 month period. These would be placed with approved counterparties as per the list of Permitted Investments approved by Council in the 2021/22 TMSS on 23 February 2021, with the expected return on these deposits commensurate with the extended duration.

Given the current low interest rate environment Council officers, in conjunction with Link Treasury Solutions Limited, will continue to review the range of all options for deposit available to the Council within its stated policy in the Treasury Management & Annual Investment Strategy approved by Council on 23 February 2021 in order to select appropriate creditworthy counterparties to ensure the security of Council funds, and from that list select the range of deposit products that offer best value to the Council's portfolio.

The Chief Officer Corporate Solutions confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2021/22.

An updated list of Countries for Deposits as at 30 September 2021 is included as Appendix 4. There are no changes from the list of Countries for Deposits as approved by Council in the 2021/22 TMSS in February 2021.

For the Council's cash-backed reserves, had the Council adopted an alternative strategy to place funds with the UK Government's Debt Management Office, rather than the current strategy to place funds with other local Authorities and on 180-day notice with Santander, this would have resulted in a loss in income for the Council of £1.045 million in 2021/22.

Expected Loan & Fund on Deposit Portfolio at 31 March 2022

Taking all of the above into account, the expected loan and funds on deposit portfolio at 31 March 2022 is shown in Tables 3 and 4 below:-

Table 3: Council's forecast Loan Portfolio at 31 March 2022

Loan Type	**31 March 2022**	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	553	8.90%
PWLB Maturity	257,002	3.18%
LOBO	20,000	4.51%
Market Loans	17,542	2.68%
Temporary Market Loans	0	n/a
Other Loans	400	0.00%
Total Loans	**295,497**	**3.25%**
Underlying Borrowing Requirement	**328,097**	
Borrowing Requirement Financed Internally (Under Borrowed)	**32,600**	

Table 4: Council's forecast Funds on Deposit Portfolio at 31 March 2022

Type	**31 March 2022**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	30,000	0.01%
Bank Call Accounts	20,000	0.01%
Bank Notice Accounts	14,985	0.58%
Bank Fixed Term Deposit Accounts	0	n/a
Other Local Authority Fixed Term Deposits	60,000	1.29%
Total Deposits	**124,985**	**0.69%**

7 Prudential Indicators 2021/22

The following prudential indicators have been refreshed from those reported to Council on 23 February 2021 in the original Treasury Management and Annual Investment Strategy Statement 2021/22.

These are technical revisions to the Prudential Indicators as a consequence of the revisions to the Council's General Services and HRA Capital Plans and are based on the actual capital plan outturns for 2020/21, and revisions to the capital expenditure and income budgets for 2021/22.

Table 5: Prudential Indicators 2021/22 – Mid Year Update

Indicator	**2021/22 Original Estimate £000's**	**2021/22 Current Position £000's**	**2021/22 Revised Estimate £000's**
2021/22 Capital Expenditure	143,617	26,034	61,027
2021/22 Required Borrowing	98,835	20,797	40,038
2021/22 Underlying Borrowing Requirement*	396,596	307,377	328,097
2021/22 Gross External Borrowing	363,996	273,701	295,497
2021/22 Over/(Under) Borrowing	-32,600	-33,676	-32,600
Operational Boundary – Borrowing	396,596	328,097	328,097
2021/22 Capital Financing Requirement**	492,510	351,645	424,011

** Excludes "On balance sheet" PPP schemes.*
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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 PPP and DBFM contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

8 Other Treasury related issues

Prudential and Treasury Management Code Revisions

CIPFA recently launched Stage 2 of the consultation on the revisions to the Prudential and Treasury Management codes of practice.

The key proposals of the Stage 2 consultation include:-

- Treasury Management Practice (TMP) 1 (risk management) to include Environmental, Social and Governance (ESG) considerations;
- A knowledge and skills schedule to be developed and maintained by organisations;
- Updated Section 8 re non-treasury investments;
- Proposed quarterly monitoring of Prudential Indicators;
- New Treasury Management Indicator for Long Term Investments;
- New Prudential Indicator – Net income from commercial and service investments as a percentage of net revenue stream;

The closing date for responses was 16 November 2021 and a joint consultation response has been submitted by the Scottish CIPFA Treasury Management Forum group in conjunction with the Scottish Directors of Finance group.

CIPFA have recently announced that, given the tight timeline for putting the Codes' changes into the TMSS and aligning with Committee cycles, there will be a 'soft implementation'. That means it will be optional to put the changes into the 2022/23 TMSS but with full implementation required for 2023/24. Officers will consider the changes that are appropriate for 2022/23 which will be incorporated in the TMSS.

The codes are expected to become fully effective from the start of the 2023/24 financial year. The review and consultation process as noted above will feed into the final versions of both codes and officers will report back to Council as required following publication. The Council's current Treasury Management Practices will also be updated to reflect the new Codes and reported to Audit Committee for review and consideration.

9 Summary

Treasury Management activity during the year to 30 September 2021 has been effective within the parameters set by the strategy for the year.

Any further long-term borrowing for the remainder of 2021/22 will be in line with the approved strategy, and reflective of the borrowing requirement arising from the General Services and HRA capital plans reported to Council on 16 November 2021.

The interest rate climate remains challenging for funds available to be placed on deposit. Officers will continue to review the opportunities available to the Council governed by the approved strategy.

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 2021/22 – General Fund Revenue report that was presented to Council on 16 November 2021.

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 will be reviewed and updated following the publication of the revised Prudential and Treasury Management Codes.

As part of their wider scope audit procedures for 2020/21, the Council's external auditors carried out an interim review of the Council's Treasury Management activity in 2020/21. This reviewed four key areas, with no material findings reported.

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
- [x] 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 Treasury Solutions Limited, 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 2021/22 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2021 to 30 September 2021
Appendix 3: Link Treasury Solutions Limited Interest Rate Forecasts
Appendix 4: Approved Countries for Deposits as at 30 September 2021

Appendix 1: Economic Update for first part of 2021/22 financial year

UK

MPC meeting 04.11.2021

The Monetary Policy Committee (MPC) voted 7-2 to leave Bank Rate unchanged at 0.10% with two members voting for an increase to 0.25% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn by a vote of 6-3.

After the Governor and other MPC members had made speeches prior to the MPC meeting in which they stressed concerns over inflation, (the Bank is now forecasting inflation to reach 5% in April when the next round of capped gas prices will go up), thus reinforcing the strong message from the September MPC meeting, financial markets had confidently built in an expectation that Bank Rate would go up from 0.10% to 0.25% at this meeting. However, these were not messages that the MPC would definitely increase Bank Rate at the first upcoming MPC meeting as no MPC member can commit the MPC to make that decision ahead of their discussions at the time. The MPC did comment, however, that Bank Rate would have to go up in the short term. It is, therefore, relatively evenly balanced as to whether Bank rate will be increased in December, February or May. Much will depend on how the statistical releases for the labour market after the end of furlough on 30th September 2021 turn out.

Information available at the December MPC meeting will be helpful in forming a picture but not conclusive, so this could cause a delay until the February meeting. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would, therefore, need to wait until the May meeting (although it also meets in March) when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation expected around that time. If the statistics show the labour market coping well during the next six months, then it is likely there will be two increases in these three meetings.

Over the next year the MPC will be doing a delicate balancing act of weighing combating inflation being higher for longer against growth being held back by significant headwinds. Those headwinds are due to supply shortages (pushing prices up and holding back production directly), labour shortages, surging fuel prices and tax increases. However, those headwinds could potentially be offset – at least partially - by consumers spending at least part of the £160bn+ of "excess savings" accumulated during the pandemic. However, it is also possible that more affluent people may be content to hold onto elevated savings and investments and, therefore, not support the economic recovery to the extent that the MPC may forecast.

The latest forecasts by the Bank showed inflation under-shooting the 3 years ahead 2% target (1.95%), based on market expectations of Bank Rate hitting 1% in 2022. This implies that rates don't need to rise to market expectations of 1.0% by the end of next year.

It is worth recalling that the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement after the MPC meeting in September yet at its August meeting it had emphasised a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. On balance, once this winter is over and world demand for gas reduces - so that gas prices and electricity prices fall back - and once supply shortages of other goods are addressed, the MPC is forecasting that inflation would return to just under the 2% target.

Just a reminder – the MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows:

1. Raising Bank Rate as "the active instrument in most circumstances".
2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
4. Once Bank Rate had risen to at least 1%, it would start selling its holdings.

Gilt yields fell after the budget led to a reduction of £57.8bn in the forecast by the OBR for the deficit this year and a cancellation of nearly all gilt sales for the remainder of the financial year. There is a delicate balancing act in forecasting gilt yields and PWLB rates over the forecast period as when Bank Rate does increase to 0.50%, the Bank will stop reinvesting maturing gilts – but at a time when the size of gilt sales has just been slashed in the budget.

US

At its 3rd November Fed meeting, the Fed decided to make a start on tapering QE purchases with the current $80bn per month of Treasury securities to be trimmed by $10bn in November and a further $10bn in December. The $40bn of MBS purchases per month will be trimmed by $5bn in each month. If the run-down continued at that pace, the purchases would cease entirely next June but the Fed has reserved the ability to adjust purchases up or down. This met market expectations. These purchases are currently acting as downward pressure on treasury yields and so it would be expected that Treasury yields would rise as a consequence over the taper period, all other things being equal.

However, on the inflation front it was still insisting that the surge in inflation was "largely" transitory. In his post-meeting press conference, Chair Jerome Powell claimed that "the drivers of higher inflation have been predominantly connected to the dislocations caused by the pandemic" and argued that the Fed's tools cannot address supply constraints. However, with the Fed now placing major emphasis on its mandate for ensuring full employment, (besides containing inflation), at a time when employment has fallen by 5 million and 3 million have left the work force, resignations have surged due to the ease of getting better paid jobs and so wage pressures have built rapidly.

With wage growth at its strongest since the early 1980s, inflation expectations rising and signs of a breakout in cyclical price inflation, particularly rents, the FOMC's insistence that this is still just a temporary shock "related to the pandemic and the reopening of the economy", does raise doubts which could undermine market confidence in the Fed and lead to higher treasury yields.

As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Inflationary pressures and erosion of surplus economic capacity look much stronger in the US compared to those in the UK, which would suggest that Fed rate increases eventually needed to suppress inflation, are likely to be faster and stronger than Bank Rate increases in the UK. This is likely to put upward pressure on treasury yields which could then spill over into putting upward pressure on UK gilt yields.

There are also possible DOWNSIDE RISKS from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

EU

The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in GDP of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time.
German general election. With the CDU/CSU and SDP both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.

China

After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

Japan

2021 has been a patchy year in combating Covid. However, after a slow start, nearly 50% of the population are now vaccinated and Covid case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July. New Prime Minister Kishida has promised a large fiscal stimulus package after the November general election – which his party is likely to win.

World growth

World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

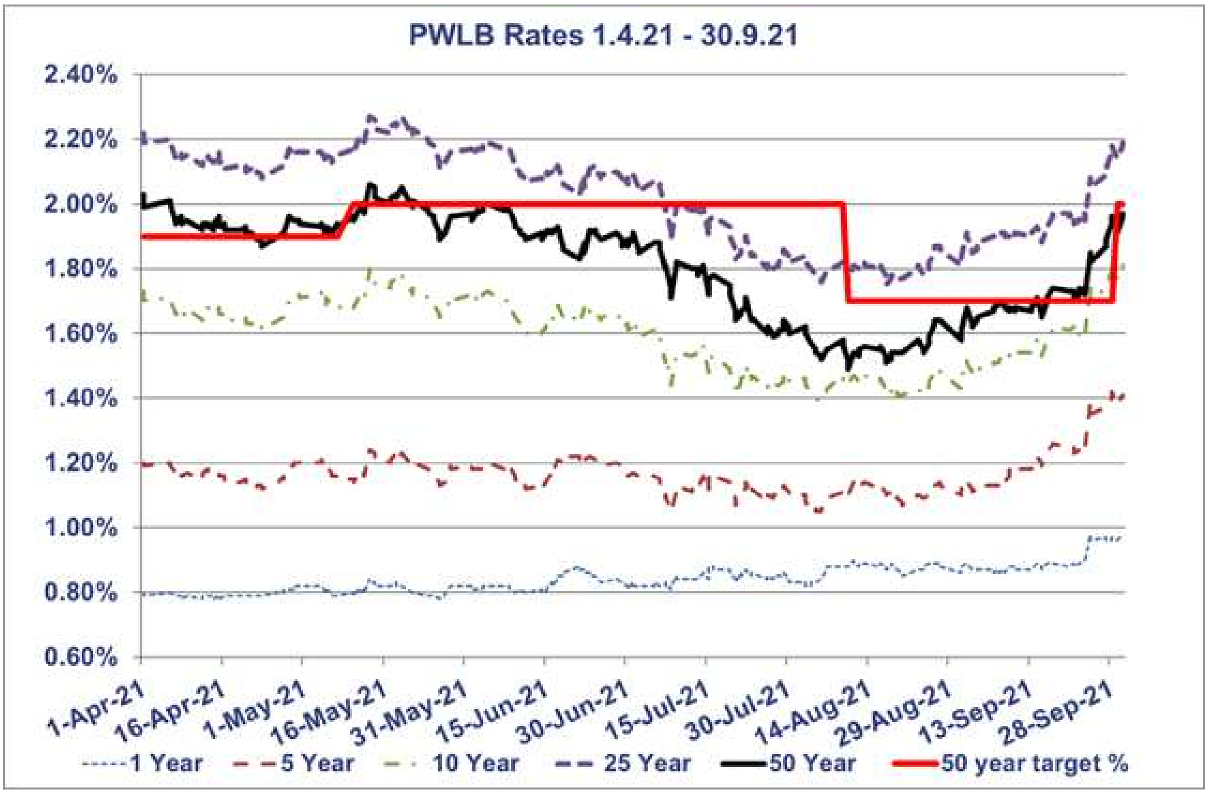
Supply shortages. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

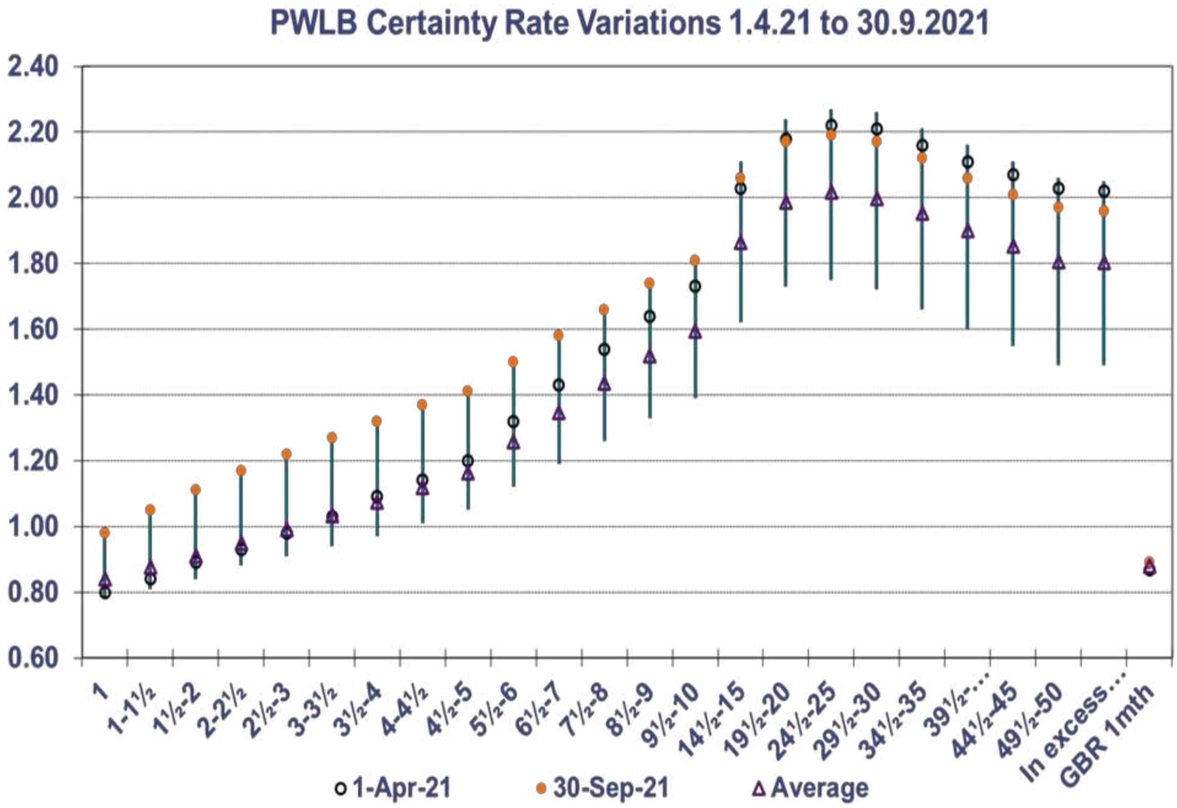
Appendix 2: PWLB Borrowing Rates 1 April 2021 to 30 September 2021

The graphs 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	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/2021	08/07/2021	05/08/2021	17/08/2021	10/08/2021
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/2021	28/09/2021	28/09/2021	13/05/2021	13/05/2021
Average	0.84%	1.16%	1.60%	2.02%	1.81%
Spread	0.20%	0.37%	0.42%	0.52%	0.57%





PWLB RATES

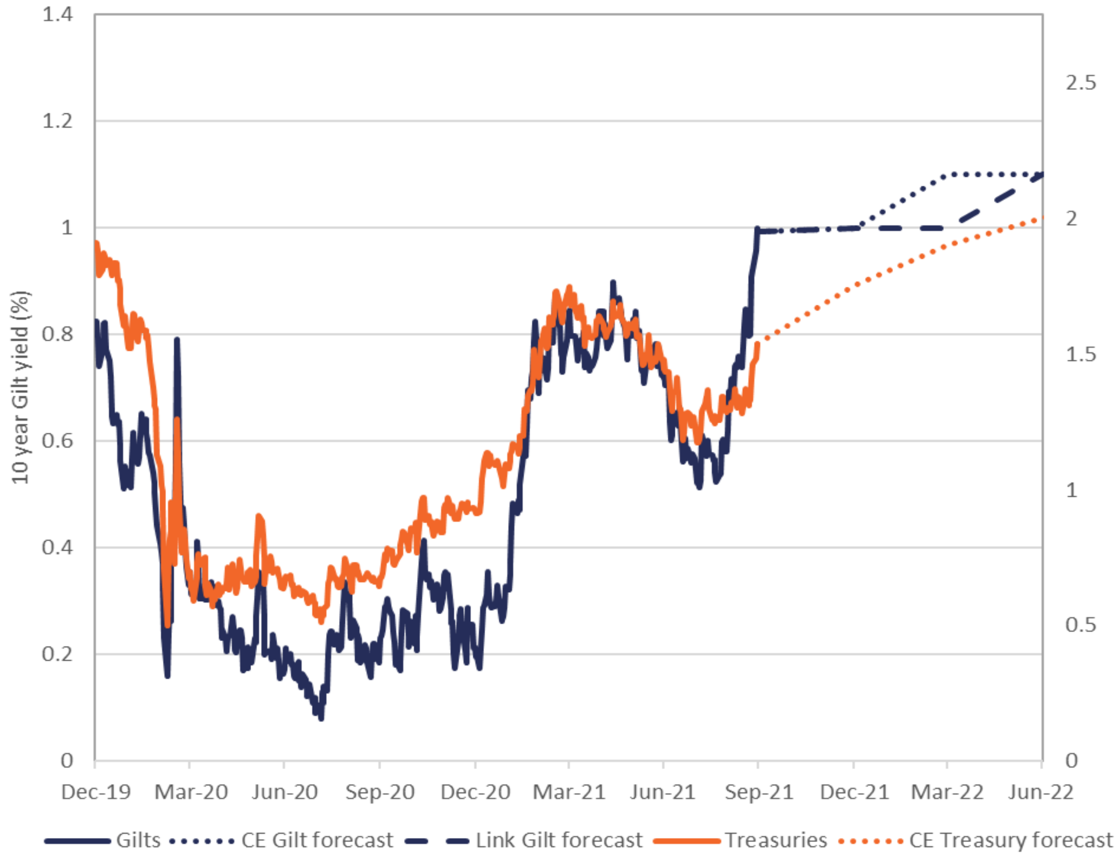
There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets. Over the year prior to the coronavirus crisis, this resulted in many bond yields up to 10 years turning negative in the Eurozone. In addition, there was, at times, an inversion of bond yields in the US whereby 10 year yields fell below shorter-term yields. In the past, this has been a precursor of a recession.

Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020 which caused gilt yields to spike up. However, yields then fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was 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 start of January 2021, all gilt yields from 1 to 8 years were negative: however, since then all gilt yields have become positive and rose sharply during the spring, especially in medium and longer-term periods, until starting a significant decline since May which was then sharply reversed in August / September. Repeated assurances by the Fed in the US, and by other major world central banks, that inflation would spike up after Covid restrictions were abolished, but would only be transitory, allayed investor fears until August / September when high inflation was again seen as a growing danger and both central banks in the US and UK gave indications that monetary policy tightening was now on the horizon. There is considerable concern that the US Fed is taking a too laid-back view that inflation pressures in the US are purely transitory and that they will subside without the need for the Fed to take significant action to tighten monetary policy. Lack of spare economic capacity and rising inflationary pressures are viewed as being much greater dangers in the US than in the UK. This could mean that rates will end up rising faster and further in the US than in the UK if inflationary pressures were to escalate; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields.

Correlation between 10 year US treasury yield and 10 year gilt yield

The Link Group forecasts have included a risk of a 75% correlation between movements in US treasury yields and gilt yields over 10 years since 2011. As US treasury yields are expected to rise faster and further than UK gilt yields, there is an upside risk to forecasts for gilt yields due to this correlation. The graph below shows actual movements in both 10 year yields and forecasts by Link (gilt only) and Capital Economics.



- Yields on 10 year Gilts and Treasuries initially both fell during the first quarter of 2020, as signs emerged that the COVID-19 virus would become a global pandemic which would lead to a sharp downturn in economic growth.
- The correlation between 10 year yields in the UK and the US lessened during the second half of 2020 when US yields displayed an increasing tendency to rise, whilst UK yields remained more range bound. This divergence was consistent with the relatively better economic performance registered by the US during the pandemic, which was aided by historically low US business inventory levels needing to be rebuilt.
- During late 2020 gilt yields rose significantly, reflecting optimism that the fast vaccine roll-out in the UK would support a strong economic recovery during 2021.
- During September 2021, treasury yields rose sharply in response to growing investor concerns around high inflation and indications from the Fed that tapering of quantitative easing purchases of treasuries are likely to occur in the near future. Gilts also rose sharply, as did investor concerns around a sharp increase in inflation in the UK which is now likely to go over 4%. In addition, the MPC meeting on 23rd September flagged up major concerns around the strength of inflation which may require Bank Rate to go up much faster than had previously been expected.

Appendix 3: Link Treasury Solutions Limited Interest Rate Forecasts

The Council's treasury advisor, Link Treasury Solutions Limited, has provided the following forecast:

Link Group Interest Rate View 8.11.21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.10	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.50	0.60	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.80	1.90	1.90	2.00	2.00
10 yr PWLB	1.80	1.90	1.90	2.00	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.40
25 yr PWLB	2.10	2.20	2.30	2.40	2.40	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70
50 yr PWLB	1.90	2.00	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50

** LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average).*

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings.

As shown in the forecast table above, five increases in Bank Rate from 0.10% to 1.25% haves now been included, one in December 2021 to 0.25%, then quarter 2 of 2022 to 0.50%, quarter 1 of 2023 to 0.75%, quarter 1 of 2024 to 1.00% and, finally, one in quarter 1 of 2025 to 1.25%.

The balance of risks to the UK:-

- The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

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

- Labour and supply shortages prove more enduring and disruptive and depress economic activity.
- Mutations of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, resulting in further national lockdowns or severe regional restrictions.
- Bank of England acts 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.
- The Government acts too quickly to cut expenditure to balance the national budget.
- UK / EU trade arrangements – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- 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 agreed a €750bn fiscal support package which has still to be disbursed. These actions will help

shield weaker economic regions in the near-term. However, in the case of Italy in the longer term, 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 the extent of credit losses resulting from the pandemic.
- German general election in September 2021. Germany faces months of uncertainty while a new coalition government is cobbled together after the indecisive result of the election. Once that coalition is formed, Angela Merkel's tenure as Chancellor will end and will leave a hole in overall EU leadership.
- Other minority EU governments. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile and, therein, impact market confidence/economic prospects and lead to increasing safe-haven flows.
- Geopolitical risks, for example in China, Iran or North Korea, but also in Europe and Middle Eastern countries, which could lead to increasing safe-haven flows.

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

- 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.
- Longer term US treasury yields rise strongly and pull gilt yields up higher than forecast.

The balance of risks to medium to long term PWLB rates: -

There is a balance of upside risks to forecasts for medium to long term PWLB

Forecasts for Bank Rate

It is not expected that the MPC will embark on a series of increases in Bank Rate of more than 1.15% during the current and next three financial years as inflation is not expected to return to being sustainably above 2% during this forecast period.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e., equities, or the safe haven of government bonds. The overall longer-run trend is for gilt yields and PWLB rates to rise.

There is likely to be exceptional volatility and unpredictability in respect of gilt yields and PWLB rates due to the following factors: -

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?

- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within the forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

A new era – a fundamental shift in central bank monetary policy

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US before consideration would be given to increasing rates.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
- For local authorities, this means that interest rates for deposits and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the

other hand, higher levels of inflation will help to erode the real value of total public debt

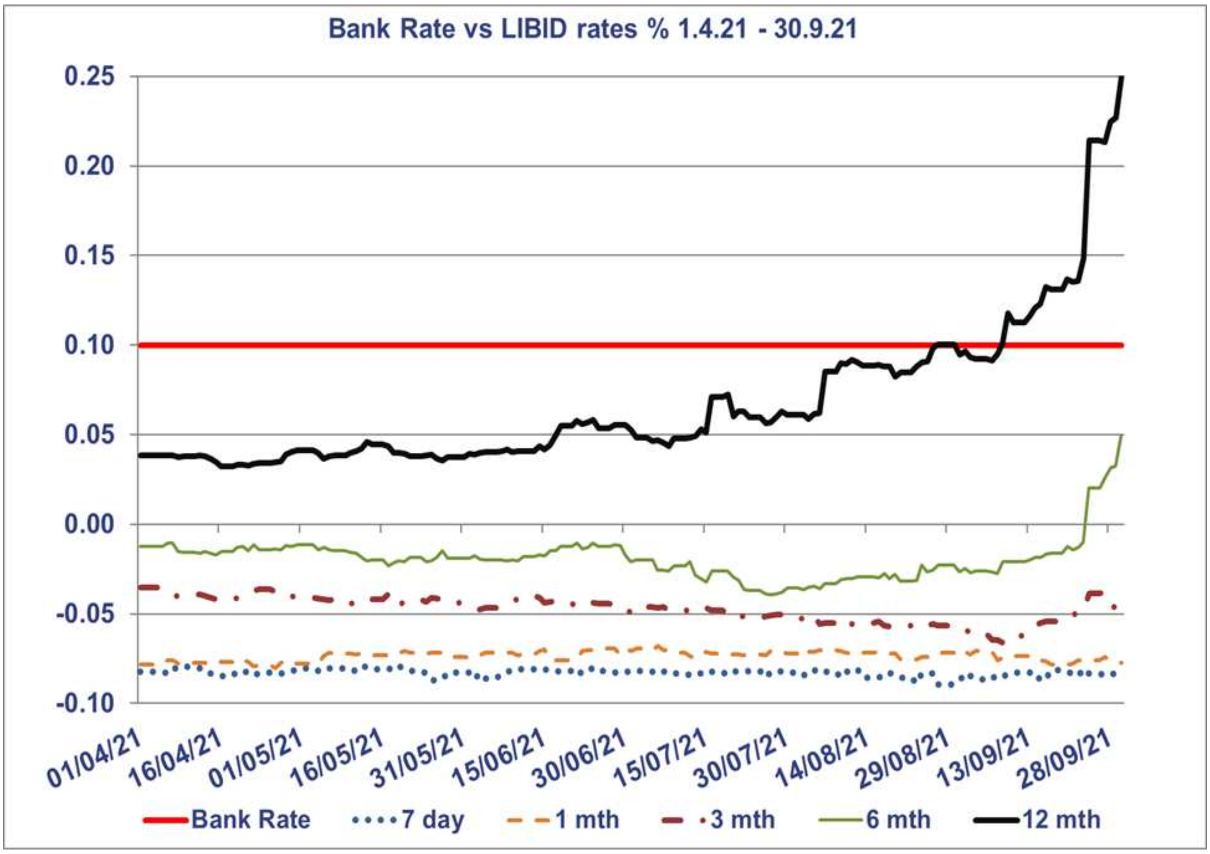
Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB non-HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- ***PWLB non-HRA Certainty Rate*** *is gilt plus 80 basis points (G+80bps)*
- **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.*

Interest Rates

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.10	-0.08	-0.07	-0.04	0.05	0.25
High Date	01/04/2021	09/04/2021	06/07/2021	01/04/2021	30/09/2021	30/09/2021
Low	0.10	-0.09	-0.08	-0.07	-0.04	0.03
Low Date	01/04/2021	27/08/2021	26/04/2021	08/09/2021	27/07/2021	16/04/2021
Average	0.10	-0.08	-0.07	-0.05	-0.02	0.07
Spread	0.00	0.01	0.01	0.03	0.09	0.22



<u>Creditworthiness</u>
Significant levels of downgrades to Short and Long Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, as economies are beginning to reopen, there have been some instances of previous lowering of Outlooks being reversed.

CDS prices

Although CDS prices (these are market indicators of credit risk) for banks (including those from the UK) spiked at the outset of the pandemic in 2020, they have subsequently returned to near pre-pandemic levels. 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 Deposit as at 7 December 2021

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.