Treasury Management Strategy Statement 2019/20

Introduction

1.0 Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

2.0 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

External Context

3.0 **Economic background:** The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council's treasury management strategy for 2019/20.

4.0 UK Consumer Price Inflation (CPI) for December was 2.0%, down from 2.2% in November 2018. The most recent labour market data shows that the number of people in work increased, the number of unemployed people was little changed but the number of people aged from 16 to 64 not working and not seeking or available to work decreased across the period.

5.0 The unemployment rate was 4.0%, it has not been lower since December 1974 to February 1975. The employment rate was 75.8%, higher for a year earlier (75.3%) and the highest estimate since comparable estimates began in 1971. Nominal wages including bonuses increased by 3.4% and wages excluding bonuses increased by 3.3%. Real wages excluding bonuses increased by 1.1% and including bonuses increased by 1.2% compared to a year earlier.

6.0 The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

7.0 Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

8.0 While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2.5% in December. Expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

9.0 **Credit outlook:** The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ring-fenced banks generally being better rated than their non-ring-fenced counterparts.

10.0 The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

11.0 European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

12.0 **Interest rate forecast:** Following the increase in Bank Rate to 0.75% in August 2018, the Council's treasury management adviser is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

13.0 The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity *(at the time of writing this commentary in mid-December).* As such, the risks to the interest rate forecast are considered firmly to the downside. ***See Appendix A.***

14.0 As a budget assumption (and not necessarily a statement of policy) for the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 1%, and that new long-term loans will be borrowed at an average rate of 3%.

Local Context

15.0 On 31st December 2018, the Council held £397m of borrowing and £114m of investments. This is set out in further detail at ***Appendix B***. Future forecasted borrowing requirements are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

£m	31.3.18 Actual	31.3.19	31.3.20	31.3.21
General Fund CFR	522.3	533.1	593.9	642.0
HRA CFR	148.6	158.4	178.2	197.0
Total CFR	**670.9**	**691.5**	**772.1**	**839.1**
Existing Borrowing	408.0	397.0	355.0	331.0
Borrowing required to meet CFR	**262.9**	**295.5**	**417.1**	**508.1**
Projected Usable Reserves	303.4	244.6	254.7	251.5
Projected Working Capital	141.3	112.5	100.0	90.0
Available Cash Reserves	**444.7**	**357.1**	**354.7**	**341.5**
Investments (or New borrowing)	**181.8**	**61.6**	**(62.4)**	**(166.6)**

16.0 The Council's CFR is greater than its borrowing, as to minimise interest costs the Council utilises its internal resources over the short term instead of undertaking more expensive external borrowing. However, the increased focus on capital investment to transform the financial position as set out in the capital pipeline report may require some new external borrowing over the coming years.

17.0 As demonstrated in the September 2018 Cabinet report “Brent Council Borrowing Strategy 2018/19 – 2020/21” the Council will need to seriously consider borrowing at some point in 2019/20. In recent years the Council’s strategy has been to maintain borrowing at the lowest level possible unless interest rate prospects present a clear case for taking long term borrowing ahead of immediate requirements. However current interest rate forecasts along with the significant levels of planned capital investment over the next three years means that this approach may no longer be sustainable or optimal.

18.0 CIPFA’s *Prudential Code for Capital Finance in Local Authorities* recommends that the Council’s total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2019/20.

BORROWING STRATEGY

19.0 The Council currently holds £397 million of loans, a decrease of £14.6 million on the previous year, following the early redemption of some of the LOBO loans and repayments on EIP borrowing. The balance sheet forecast in table 1 shows that the Council expects to borrow up to £166 million by 2020/21 however this is largely dependent on how the capital programme progresses. In accordance with the September 2018 strategy report the Council may also borrow additional sums to pre-fund future years’ requirements, providing this does not exceed the authorised limit for borrowing of £1.1 billion.

20.0 **Objectives:** The Council’s chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council’s long-term plans change is a secondary objective.

21.0 **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Council’s borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this ‘cost of carry’ and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

22.0 The Council will also be seriously considering the use of forward starting loans during 2019/20, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

23.0 In addition to above, the Council may borrow short-term loans to cover unplanned cash flow shortages.

Sources of borrowing: The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the local Brent Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

24.0 **Other sources of debt finance:** In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

25.0 Although we do not anticipate entering into any new PFI arrangements, we would not rule this out should the terms become sufficiently favourable. However, the council has previously raised the majority of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

26.0 **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

27.0 **LOBOs:** The Council holds £70.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan. Although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

28.0 **Short-term and variable rate loans:** These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

29.0 **Debt rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving and/or a reduction in risk.

INVESTMENT STRATEGY

30.0 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £190 and £89 million. These balances are forecast to decline as the Councils begins the implementation of its ambitious capital programme and pipeline.

31.0 The 2018/19 investment strategy allowed the Council flexibility to invest cash for periods of up to 370 days with the ability to lend any amount to any UK local government body for up to 5 years. The minimum long term rating for counterparties is A- (or equivalent) whilst the prudential indicators allowed up to £40m to be invested for longer than 364 days.

32.0 **Objectives:** The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

33.0 **Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to further diversify into higher yielding asset classes during 2019/20. However it is worth noting that this approach might be limited to the extent that this the capital investment plans are delivered in line with current expectations. Should this prove to be the case, surplus funds may not be available to invest over longer durations as set out below.

34.0 The average rate of interest received on investments during the year to December 18 was 0.71%. Comparison data for other local authorities from Arlingclose's benchmarking club (which uses the data of 136 Local Authorities) places Brent around average compared to our peers - ***Appendix C***. However, this strategy now provides the opportunity improve this performance. During the first quarter of 19/20 council officers, in conjunction with our advisors will undertake a more detailed review to assess the potential for realistically doubling the current average rate of return by making use of the full range of options listed in paragraphs 42.0 – 49.0 and contained within this strategy.

35.0 The majority of the Council's surplus cash is currently invested short-term with other Local Authority's, money market funds and certificates of deposit. This diversification will therefore represent a change in strategy over the coming year.

36.0 In order to diversify a portfolio largely invested in cash, for 19/20 investments will be placed with a number of approved counterparties over a range of maturity periods. Maximum investment levels with each counterparty will be set by the Chief Finance Officer to ensure that prudent diversification is achieved.

37.0 The minimum credit rating for non-UK sovereigns will be set at AA+ (or equivalent) and the minimum long term rating for counterparties is A- (or equivalent). Within these criteria the Chief Finance Officer (CFO) will have discretion to accept or reject individual institutions as counterparties on the basis of any information which may become available.

38.0 The Council uses the lowest rating quoted by the main rating agencies, as recommended by CIPFA. Where instrument credit ratings are available, the instrument credit rating will be used if different from the counterparty rating. Credit ratings are monitored continually by the Council, using the advice of Arlingclose on ratings changes, and action taken as appropriate.

39.0 Any institution will be suspended or removed should any factors give rise to concern, and caution will be paramount in reaching any investment decision regardless of the counterparty or the circumstances. Should an entities credit rating be downgraded so that it does not meet the Council's approved criteria then:

- No new investments will be made;
- Full consideration will be made to the recall or sale of existing investments with the affected counterparty.

40.0 Having an appropriate lending list of counterparties, remains critically important to protecting Brent's investments. A list of extremely secure counterparties would be very small, and the limits with each would be correspondingly high. This would expose the Council to a risk of an unlikely but potentially large loss. This arises because the arrangements for dealing with banks in difficulty now require a loss to be imposed on various categories of liabilities of the banks to allow the bank to recapitalise itself and continue in business (sometimes referred to as bail in).

41.0 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

42.0 **Unsecured deposits:** unsecured deposits with banks could be exposed to credit loss by the 'bail-in' process. This is where depositors are expected to make a significant contribution to recapitalise a bank that is failing or likely to fail before government support is provided and public money is invested in the organisation. There is no upper limit to the maximum credit loss that the authority could suffer in the event of a bail-in scenario.

43.0 **Secured deposits:** secured deposits of various kinds are not included in bail in provisions where investments are secured on the bank's assets. It is likely that the Council's preferred instruments in lending to institutions without some kind of government guarantee will increasingly be in the form of secured or marketable instruments. The Council and its advisors remain alert for signs of credit or market distress that might adversely affect the Council.

44.0 **Money market funds (MMFs):** will be utilised but good treasury management practice prevails, and whilst MMFs provide good diversification, the Council will also seek to mitigate operational risk by using at least two MMFs where practical. They will not exceed 0.5% of the net asset value of the MMF. *In addition, each Fund will be limited to a maximum deposit of £20m.*

45.0 **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. *Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.*

The investment strategy will provide flexibility to invest cash for longer periods in order to access higher investment returns. *The upper limit for lending beyond a year is £50m*. In practice, lending for more than one year will be only to institutions of the highest credit quality and at rates which justify the liquidity risk involved. Marketable instruments may have longer maturities, though the maturity will be considered in conjunction with the likely liquidity of the market and credit quality of the institution. *Other than UK Central Government the council may invest its surplus funds subject to a maximum duration of 20 years.*

Alternative investment options will include:

46.0 **Corporate bonds:** These can give significantly higher yields than our current deposits but give exposure to risks from economic, commercial and operational difficulties. Diversification would involve investing small amounts with a large number of companies or buying diversified Funds. Seeking additional security could involve exchanging our deposit for known high credit quality assets, or a claim on a pool of assets. Seeking capital strength would involve investing in companies with high levels of assets in relation to liabilities or a strong fixed asset base, or whose business is not subject to marked fluctuations in activity or profitability.

47.0 **Registered Providers (Housing Associations and Registered Social Landlords):** Loans and bonds issued by RP's have been included as an approved investment counterparty for 2019/20. Any investments with Registered Providers will be analysed on an individual basis and discussed with Arlingclose prior to investing. *Investments with registered providers will be limited to £20m in 2019/20.*

48.0 **Collective Investment Schemes (Pooled Funds):** Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. The Council has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Council to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns. Investments in pooled funds will be undertaken with advice from Arlingclose. Although considered as pooled funds, MMF's are discussed separately in paragraph 42. The Council currently has no investments in Pooled Funds (other than MMFs) at present, but may make prudent use of them in the future. *Investments in pooled funds will be limited to £20m in 2019/20.*

49.0 **Real estate investment trusts:** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties*. Investments in REITs will be limited to £20m in 2019/20.*

50.0 **Operational bank accounts:** The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services. These are not classed as investments but are at risk of bank bail-in. The Council banks with National Westminster Bank (NatWest) who meet the Council's minimum credit criteria. Should Natwest's creditworthiness deteriorate below the Council's minimum credit criteria, then as far as is consistent with operational efficiency, no money will be placed with NatWest and credit balances in the various Council accounts will be kept to a minimum level.

51.0 **Investment limits**: The Council's revenue reserves available to cover investment losses are forecast to be £240 million on 31st March 2019. In order that no more than 10% of available reserves will be put at risk in the case of a single default, *the maximum that will be lent to any one organisation (other than the UK Government) will be £20 million*. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

52.0 **Liquidity management:** The Council uses internal purpose-built cash flow modelling tools to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

TREASURY MANAGEMENT INDICATORS

53.0 The Council measures and manages its exposures to treasury management risks using the following indicators.

54.0 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Table 2

Credit risk indicator	**Target**
Portfolio average credit rating	A

55.0 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling [three] month period, without additional borrowing.

Table 3

Liquidity risk indicator	**Target**
Total cash available within 3 months	£50m

56.0 **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Table 4

Interest rate risk indicator	**Limit**
Upper limit on one-year revenue impact of a 1% rise in interest rates	£5m
Upper limit on one-year revenue impact of a 1% fall in interest rates	£5m

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

57.0 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Table 5

Refinancing rate risk indicator	**Upper limit**	**Lower limit**
Under 12 months	40%	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	60%	0%
10 years and within 20 years	75%	0%
20 years and within 30 years	75%	0%
30 years and within 40 years	75%	0%
Over 40 years	75%	0%

Time periods start on the first day of each financial year. LOBOs are classified as maturing on the next call date i.e. the earliest date that the lender can require repayment.

58.0 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Table 6

Price risk indicator	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£50m	£50m	£50m

Related Matters

59.0 The CIPFA Code requires the Council to include the following in its treasury management strategy.

60.0 **Financial Derivatives:** The Authority does not currently use standalone financial derivatives (such as swaps, forwards, futures and options) and will only do so where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives will not be subject to this policy. Where schemes contain an embedded derivative they will be subject to evaluation as part of the appraisal of the particular scheme.

61.0 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and any relevant foreign country limit.

62.0 The Authority will only use derivatives after seeking expertise, receiving a legal opinion and ensuring officers have the appropriate training for their use.

63.0 **Housing Revenue Account:** As of 1 April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. Individual loans or parts of loans have been allocated to the HRA, on the basis of achieving the same long term rate as that which applied to the General Fund at the self-financing date.

64.0 Differences between the value of the HRA loans pool and the HRA's underlying need to borrow results in a notional element of internal borrowing. This balance will be assessed over the year and interest charged to the HRA at an appropriate rate for short term borrowing. The HRA will also hold reserves and balances which will be invested with the Council, and interest will be paid on identified balances at a rate which recognises that any investment risk is borne by the General Fund.

65.0 **Markets in Financial Instruments Directive**: The MiFID II regulations took effect from January 2018 which saw the council reclassified as a retail client with the opportunity to opt up to professional client status. Retail clients have access increased protection however this would be balanced against potentially higher fees and access to a more limited range of products. The council has opted up to professional client status with its providers of financial services, including advisors, banks, brokers and fund managers. The CFO believes this to be the appropriate status for the Council's treasury management activities.

Other options considered

66.0 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The strategy below in Table 7 represents alternative approaches, along with the associated financial and risk management implications.

Table 7: Alternative Strategies

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A – Arlingclose Economic & Interest Rate Forecast December 2018

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitionary period following the UK's official exit from the EU.

- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.

- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.

- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.

- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.

- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitionary period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.17**
Arlingclose Central Case	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.13**
Downside risk	0.00	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	**-0.85**
3-mth money market rate														
Upside risk	0.10	0.10	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	**0.17**
Arlingclose Central Case	**0.90**	**0.95**	**1.10**	**1.30**	**1.40**	**1.40**	**1.40**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.27**
Downside risk	-0.20	-0.45	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	**-0.76**
1-yr money market rate														
Upside risk	0.20	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.33**
Arlingclose Central Case	**1.15**	**1.25**	**1.35**	**1.50**	**1.70**	**1.60**	**1.50**	**1.40**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.40**
Downside risk	-0.35	-0.50	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	**-0.77**
5-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.15**	**1.25**	**1.35**	**1.50**	**1.50**	**1.40**	**1.35**	**1.35**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**	**1.33**
Downside risk	-0.50	-0.60	-0.65	-0.80	-0.80	-0.70	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	**-0.66**
10-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.50**	**1.65**	**1.70**	**1.80**	**1.80**	**1.75**	**1.75**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**
Downside risk	-0.55	-0.70	-0.70	-0.80	-0.80	-0.75	-0.75	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	**-0.71**
20-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**2.00**	**2.10**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.18**
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
50-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.90**	**1.95**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**1.99**
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Appendix B – Existing Investment & Debt Portfolio Position

	Dec-18 Actual Portfolio £m	Dec-18 Average Rate %
External borrowing:		
Public Works Loan Board	311.4	4.83%
LOBO loans from banks	70.5	4.64%
Fixed Rate Loans	15	4.27%
Total external borrowing	**396.9**	**4.78%**
Other long-term liabilities:		
Private Finance Initiative	26.5	
Finance Lease	2.6	
Total other long-term liabilities	**29.1**	
Total gross external debt	**426.0**	
Treasury investments:		
Banks & building societies (unsecured)	5.2	
Government (incl. local authorities)	70.8	0.71%
Money Market Funds	37.7	
Total treasury investments	**113.7**	**0.71%**
Net debt	**312.3**	

Appendix C – Internal Investments: Average Rate vs Credit Risk