# Treasury Management Strategy Statement 2020/21

## Introduction

1.0 Treasury management is the management of the Authority's cash flows, borrowing and investments, and the associated risks. The Authority 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 Authority's prudent financial management.

2.0 Treasury risk management at the Authority 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 Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

## Local Context

3.0 On 31st December 2019, the Authority held £491.5m of borrowing (£386.5m long term and £105m short term) and £86.3m of investments. This is set out in further detail at ***Appendix B***. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

| £m | 31.3.19 Actual | 31.3.20 Forecast | 31.3.21 Forecast | 31.3.22 Forecast |
|---|---|---|---|---|
| **General Fund CFR** | 527.1 | 588.3 | 686.7 | 809.7 |
| **HRA CFR** | 161.6 | 233.5 | 283.2 | 325.5 |
| **Total CFR** | **688.7** | **821.8** | **969.9** | **1,135.2** |
| **Existing Borrowing** | 396.3 | 369.8 | 341.1 | 316.1 |
| **Borrowing required to meet CFR** | **292.4** | **451.9** | **628.8** | **819.1** |
| | | | | |
| **Projected Usable Reserves** | 368.4 | 289.8 | 341.5 | 350.1 |
| **Projected Working Capital** | 27.2 | (20.0) | 50.0 | 30.0 |
| **Available Cash Reserves** | **395.6** | **269.8** | **391.5** | **380.1** |
| | | | | |
| **Investments (or New borrowing)** | **103.2** | **(182.2)** | **(237.3)** | **(439.0)** |

4.0 The Council's Capital Financing Requirement (CFR) is greater than its borrowing. This is because the Council has minimised its interest costs by utilising 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 has reduced the Council's investments during 2019/20.

5.0 As demonstrated in the September 2018 Cabinet report "Brent Council Borrowing Strategy 2018/19 – 2020/21" the Council has a borrowing requirement during 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 and actual capital investment means that this approach is no longer sustainable or optimal.

6.0 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2020/21.

Borrowing Strategy

7.0 The Council currently holds £491.5m of loans, an increase of £95m on the previous year, due to the decrease in internal cash reserves and planned capital expenditure. The balance sheet forecast in table 1 shows that the Council expects to borrow up to £237m 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 £1.2 billion.

8.0 **Objectives:** The Council's main 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 Authority's long-term plans change is a secondary objective.

9.0 **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 short term 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. The cost of carry exercise which will evaluate the cost of borrowing now to borrowing in the future will determine whether the Council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

10.0 The Council is also utilising forward starting loans during 2020/21, 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.

11.0 In addition to above, the Authority may borrow short-term loans to cover temporary cash flow pressures.

**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

12.0 **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

13.0 The Council has previously raised the majority of its long-term borrowing from the PWLB but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive options. The Authority will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

14.0 **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. The recent PWLB rate rise has boosted hopes that the UK Municipal Bonds Agency can finally issue its first bond. The MBA has failed to get its first bond off the ground since its launch more than five years ago, partly due to the low rates on offer to councils through the PWLB but also due to concerns around the joint and several liability that requires all members to collectively and individually guarantee the debt of each borrower. However, the 1% hike in the PWLB's borrowing rates has given fresh impetus to the agency's hopes of getting an issue off the ground and the MBA will be a core part of the councils borrowing strategy going forward.

15.0 **LOBOs:** The Council holds £70m 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 Authority has the option to either accept the new rate or to repay the loan at no additional cost. Although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

16.0 **Short-term and variable rate loans:** These loans leave the Authority 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.

17.0 **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 Authority 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 or a reduction in risk.

**Investment Strategy**

18.0 The Council holds 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 from £116m to £32m (a downward trend) due to capital expenditure utilising the Council's internal cash reserves. These balances are expected to remain low as the Council enters a borrowing period with cash available to invest for relatively short periods.

19.0 **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.

20.0 **Negative interest rates:** If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

21.0 **Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to diversify into higher yielding asset classes during 2020/21. This diversification will represent a continuation of the new strategy adopted in 2018/19. However, it is worth noting that this approach will 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.

22.0 The average rate of interest received on short-term investments during the year to December 19 was 0.72%. 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. Due to the authorities borrowing requirement, there is unlikely to be scope to improve the short term investment returns achieved as liquidity of the surplus funds will play a key role.

23.0 The majority of the Council's surplus cash is currently invested short-term with other Local Authority's and money market funds. The Council will maintain a minimum investment balance of £10m to ensure the Council complies with the requirements to be a professional client under MIFID II regulations.

24.0 **Credit Rating:** 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 Director of Finance will have discretion to accept or reject individual institutions as counterparties on the basis of any information which may become available.

25.0 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 so an investment decision is not made solely based on credit ratings.

26.0 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.

27.0 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).

28.0 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. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

29.0 **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. Investments in unsecured deposits will be limited to £20m.

30.0 **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. Investments in secured deposits will be limited to £20m.

31.0 **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.

32.0 **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 £500m. 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 30 years.

**Alternative investment options will include:**

33.0 **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 market fluctuations in activity or profitability. Investment in corporate bonds will be limited to £20m in 2020/21.

34.0 **Registered Providers (Housing Associations and Registered Social Landlords):** Loans and bonds issued by RP's have been included as an approved investment counterparty for 2020/21. 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 2020/21 for up to 5 years.

35.0 **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 44. 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 2020/21.

36.0 **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. The risk with any investments in REITs is that shares cannot be withdrawn but can be sold on the stock market to another investor which leaves the Council open to market risk. Investments in REITs will be limited to £20m in 2020/21.

37.0 **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 still subject to the risk of a bank bail-in, and balances will therefore be kept to a minimum. 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.

38.0 **Investment limits:** The Council's reserves available to cover investment losses are forecast to be £290m on 31st March 2020. 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 and Council subsidiaries) will be £20m. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

Table 2: Investment Limits

| | **Credit Quality** | **Cash limit** |
|---|---|---|
| Any single organisation, except the UK Central Government | A- Or equivalent | £20m |
| UK Government | Any | Unlimited for up to 50 years |
| Foreign countries | AA+ or equivalent | £20m per organisation |
| Registered providers and registered social landlords | A- Or equivalent | £20m per provider for up to 5 years |
| Loans to subsidiaries | n/a | £500m |
| Money market funds | A- Or equivalent | Lower of 5% of total net assets of the fund or £20m |
| Real estate investment trusts | A- Or equivalent | £20m |
| Corporate Bonds | A- Or equivalent | £20m |

| | | |
|---|---|---|
| Any group of pooled funds under the same management | A- Or equivalent | £20m |
| Secured deposits | A- Or equivalent | £20m |

39.0 **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**

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

41.0 **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 3: Credit risk indicator

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

42.0 **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 4: Liquidity risk indicator

| **Liquidity risk indicator** | **Target** |
|---|---|
| Total cash available within 3 months | £20m |

43.0 **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 5: Interest rate risk indicator

| **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.*

44.0 **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 6: Refinancing rate risk indicator

| 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.*

45.0 **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 7: Price risk indicator

| Price risk indicator | 2020/21 | 2021/22 | 2022/23 |
|---|---|---|---|
| Limit on principal invested beyond year end | £500m | £550m | £600m |

**Related Matters**

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

47.0 **Financial Derivatives:** Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

48.0 The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) 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, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

49.0 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 the relevant foreign country limit.

50.0 In line with the CIPFA Code, the Authority will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

51.0 **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.

52.0 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.

53.0 **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 Director of Finance believes this to be the appropriate status for the Council's treasury management activities.

54.0 **Other Options Considered:** The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Council believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Table 8: 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 |

## External Context

55.0 **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 Authority's treasury management strategy for 2020/21. The General Election has removed some uncertainty within the market, however following the expected Withdrawal Bill, uncertainties around the future trading relationship with the EU remain.

56.0 GDP growth rose by 0.4% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.1% from 1.2%. Services, construction and production added positively to growth, by 0.5%, 1.2% and 0.1% respectively, while agriculture recorded a fall of 0.1%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

57.0 The headline rate of UK Consumer Price Inflation remained the same in November 2019 at 1.5% year-on-year, the same as October 2019, however continuing to fall from highs of 2.1% in July and April 2019 as accommodation services and transport continued to contribute to a level of inflation below the BOE target of 2%. Labour market data continues to be positive. The ILO unemployment rate continues to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, adjusting for inflation this means real wages were only up by 0.9% in October 2019 and only likely to have a moderate impact on household spending.

58.0 Domestic inflationary pressures have abated, as domestic gas and electricity price freezes have taken effect until 2020. The price of oil has fallen through the year, despite a rise in prices in December 2019. The limited inflationary pressure from real wages will likely keep inflation below the Bank of England target of 2%. The Bank of England maintained Bank Rate to 0.75% in November following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

59.0 The US economy has continued to perform relatively well compared to other developed nations; however, the Federal Reserve has started to unwind its monetary tightening through 2019. The Federal Reserve has cut rates three times to 1.5% - 1.75%, to stimulate growth as GDP growth has started to fall (to 2.1%).

60.0 The fallout from the US-China trade war continues which, risks contributing to a slowdown in global economic activity in 2019. Recent suggestions have been an initial compromise and potential unwinding of tariffs; however, this can change quickly. Slow growth in Europe, combined with changes in leadership at the ECB and IMF has led to a change of stance in 2019. Quantitative easing has continued and been extended.

61.0 **Credit outlook:** The recent Bank of England stress tests assessed all seven UK banking groups. The tests scenarios include deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. All seven banks passed the test on both a CET1 ratio and a leverage ratio basis. Major banks have steadily increased their capital for many years now. However, there are a number of shortcomings in the Bank's approach; timeliness as the results are over 11 months of out date when they are published, being based on end-2018 balance sheets; ringfencing, as the tests ignore the restrictions on transferring capital between ringfenced "retail" banks and non-ringfenced "investment" banks within the larger groups and; coverage – the tests should be expanded to cover a wider range of UK banks and building societies.

62.0 The Bank of England will seek to address some of these issues in 2020, when Virgin Money/Clydesdale will be added to the testing group and separate tests will be included of ringfenced banks.

63.0 Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

64.0 Looking forward, the potential for a "no-deal" Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

65.0 **Interest rate forecast:** The Authority's treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the upcoming general election, the need for greater clarity on Brexit and the continuing global economic slowdown. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal.

66.0 Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

67.0 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%.

**Appendix A – Arlingclose Economic & Interest Rate Forecast November 2019**

**Underlying assumptions:**

- The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased.

- Some positivity on the trade negotiations between China and the US has prompted worst case economic scenarios to be pared back. However, information is limited, and upbeat expectations have been wrong before.

- Brexit has been delayed until 31 January 2020. While the General Election has maintained economic and political uncertainty, the opinion polls suggest the Conservative position in parliament may be strengthened, which reduces the chance of Brexit being further frustrated. A key concern is the limited transitionary period following a January 2020 exit date, which will maintain and create additional uncertainty over the next few years.

- UK economic growth has stalled despite Q3 2019 GDP of 0.3%. Monthly figures indicate growth waned as the quarter progressed and survey data suggest falling household and business confidence. Both main political parties have promised substantial fiscal easing, which should help support growth.

- While the potential for divergent paths for UK monetary policy remain in the event of the General Election result, the weaker external environment severely limits potential upside movement in Bank Rate, while the slowing UK economy will place pressure on the MPC to loosen monetary policy. Indeed, two MPC members voted for an immediate cut in November 2019.

- Inflation is running below target at 1.7%. While the tight labour market risks medium-term domestically-driven inflationary pressure, slower global growth should reduce the prospect of externally driven pressure, although political turmoil could push up oil prices.

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

**Forecast:**

- Although we have maintained our Bank Rate forecast at 0.75% for the foreseeable future, there are substantial risks to this forecast, dependant on General Election outcomes and the evolution of the global economy.

- Arlingclose judges that the risks are weighted to the downside.

- Gilt yields have risen but remain low due to the soft UK and global economic outlooks. US monetary policy and UK government spending will be key influences alongside UK monetary policy.

- We expect gilt yields to remain at relatively low levels for the foreseeable future and judge the risks to be broadly balanced.

| | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | | |
| Upside risk | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | **0.21** |
| Arlingclose Central Case | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | 0.75 |
| Downside risk | -0.50 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | **-0.73** |
| | | | | | | | | | | | | | | |
| 3-month money market rate | | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.10 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | **0.25** |
| Arlingclose Central Case | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | **0.75** | 0.75 |
| Downside risk | -0.50 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | **-0.73** |
| | | | | | | | | | | | | | | |
| 1yr money market rate | | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.25 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | **0.23** |
| Arlingclose Central Case | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | **0.85** | 0.85 |
| Downside risk | -0.30 | -0.50 | -0.55 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | **-0.60** |
| | | | | | | | | | | | | | | |
| 5yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.40 | 0.45 | 0.45 | 0.45 | **0.37** |
| Arlingclose Central Case | **0.50** | **0.50** | **0.50** | **0.55** | **0.60** | **0.60** | **0.60** | **0.60** | **0.60** | **0.60** | **0.60** | **0.60** | **0.60** | 0.57 |
| Downside risk | -0.35 | -0.50 | -0.50 | -0.55 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | **-0.56** |
| | | | | | | | | | | | | | | |
| 10yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.30 | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.40 | 0.40 | 0.45 | 0.45 | **0.37** |
| Arlingclose Central Case | **0.75** | **0.75** | **0.80** | **0.80** | **0.85** | **0.85** | **0.90** | **0.90** | **0.95** | **0.95** | **1.00** | **1.00** | **1.00** | 0.88 |
| Downside risk | -0.40 | -0.40 | -0.40 | -0.40 | -0.45 | -0.45 | -0.45 | -0.45 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | **-0.45** |
| | | | | | | | | | | | | | | |
| 20yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.30 | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.40 | 0.40 | 0.45 | 0.45 | **0.37** |
| Arlingclose Central Case | **1.20** | **1.20** | **1.25** | **1.25** | **1.25** | **1.30** | **1.30** | **1.30** | **1.35** | **1.35** | **1.35** | **1.40** | **1.40** | 1.30 |
| Downside risk | -0.40 | -0.40 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.50 | -0.50 | **-0.45** |
| | | | | | | | | | | | | | | |
| 50yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.30 | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.40 | 0.40 | 0.45 | 0.45 | **0.37** |
| Arlingclose Central Case | **1.20** | **1.20** | **1.25** | **1.25** | **1.25** | **1.30** | **1.30** | **1.30** | **1.35** | **1.35** | **1.35** | **1.40** | **1.40** | 1.30 |
| Downside risk | -0.40 | -0.40 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.45 | -0.50 | -0.50 | **-0.45** |

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80%
PWLB Local Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

**Appendix B – Existing Investment & Debt Portfolio Position**

| | 31/12/19 Actual Portfolio £m | 31/12/19 Average Rate % |
|---|---|---|
| **External borrowing:** | | |
| Public Works Loan Board | **301.0** | **4.9** |
| Local authorities | **105.0** | **0.9** |
| LOBO loans from banks | **70.5** | **4.8** |
| Other loans | **15.0** | **4.3** |
| **Total external borrowing** | **491.5** | **3.7** |
| **Other long-term liabilities:** | | |
| Private Finance Initiative | 23.6 | |
| Finance Leases | 5.2 | |
| Transferred Debt | 0.0 | |
| **Total other long-term liabilities** | 28.8 | |
| **Total gross external debt** | 520.3 | |
| **Treasury investments:** | | |
| Banks & building societies (unsecured) | 0.2 | 0.0 |
| Government (incl. local authorities) | 5.0 | 0.8 |
| Money Market Funds | 81.3 | 0.7 |
| **Total treasury investments** | 86.5 | 0.7 |
| **Net debt** | 433.8 | |

**Appendix C – Internal Investments: Average Rate vs Credit Risk**