

Date: **27th November 2020**

Subject: **Treasury Management Interim Report 2020-2021**

Report of: **Steve Wilson, Treasurer of the GMCA**

PURPOSE OF REPORT

To report the Treasury Management activities of the Greater Manchester Combined Authority (GMCA) during the first six months of 2020-21.

RECOMMENDATIONS:

The Audit Committee is asked to note the contents of the report

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BACKGROUND PAPERS:

Treasury Management Strategy Statement, Borrowing Limits and Annual Investment Strategy 2020-21.

TRACKING/PROCESS		
Does this report relate to a Key Decision, as set out in the GMCA Constitution or in the process agreed by the AGMA Executive Board		No
EXEMPTION FROM CALL IN		
Are there any aspects in this report which means it should be considered to be exempt from call in by the AGMA Scrutiny Pool on the grounds of urgency?		No
AGMA Commission	TfGMC	Scrutiny Pool
N/A	N/A	N/A

1 INTRODUCTION AND BACKGROUND

1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities. The Authority has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by the Authority of a Treasury Policy Statement which sets out Authority, Committee and Chief Financial Officer responsibilities, and delegation and reporting arrangements. This was approved by the Authority on the 27th April 2012, as part of the revised Treasury Management Strategy Statement for 2012-13.

1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2011, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement, the requirement to report to members at least twice a year on the activities of the Treasury Management function. This report, along with the Outturn Treasury Management report received by the Audit Committee of the GMCA on the 25th September 2020, therefore ensures that the Authority meets the requirements of the Strategy, and therefore the Code.

1.3 Treasury Management in this context is defined as:

‘The management of the organisation’s 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’.

1.4 This annual report covers:

Section 1: Introduction and Background
Section 2: Key Consideration Update
Section 3: The GMCA’s Portfolio Position as at 30th September 2020
Section 4: Review of Economic Conditions
Section 5: Public Works Loans Board (PWLB) Consultation
Section 6: External Borrowing for 2020-21 to date
Section 7: Compliance with Prudential Indicators and Treasury Limits
Section 8: Investment Strategy for 2020-21 to date
Section 9: Temporary Borrowing and Investment Outturn for 2020-21 to date
Section 10: Conclusion

Appendix A: Public Works Loans Board (PWLB) Interest Rates
Appendix B: Treasury Management Prudential Indicators
Appendix C: Review of Economic Conditions, provided by advisors
Appendix D: Glossary of Terms

2. KEY CONSIDERATIONS UPDATE

2.1 Contained within the GMCA Outturn Report 2019-20, ongoing considerations which have been presented to the Audit Committee on 25th of September 2020 as well as new considerations, are detailed below:

- European Investment Bank (EIB)
- Lender Option Borrower Options (LOBOs)
- Negative Interest Rates

- End of Transition Period

European Investment Bank (EIB)

- 2.2 Discussions are continuing regarding a new loan for the Trafford Park Metrolink Scheme and a draft contract has been received by GMCA for a loan. To allow the signing of the loan agreement in a timely manner the Audit Committee previously delegated to the Treasurer, in conjunction with the Monitoring Officer, authority to finalise the loan agreement. Currently EIB rates are being monitored to determine whether this provides a competitive source of long term borrowing.

Lender Option Borrower Options (LOBOs)

- 2.3 Within the portfolio there were originally two Lender Option Borrower Option loans with Barclays which were taken out in 2005 and 2006 for a period of 60 years. At Barclays' initiative in 2018 these were converted to standard vanilla loans. Along with a number of Local Authorities, GMCA continues to engage with specialist legal support to pursue a claim against Barclays in relation to the historic elements of their LOBO loans. This claim remains ongoing.

Negative Interest Rates

- 2.4 Negative interest rates in the U.K. are unprecedented, however remain a feasible option for the Bank of England. To date the Bank of England rate remains at 0.10%. Despite the U.K. bank rate remaining positive, the Debt Management Office (DMO) has started offering investments at a negative rate from the 25th of September 2020. This means that any investments with the DMO would result with a cost to the Authority. Officers view this as an option of last resort if alternative positive returns are achievable.
- 2.5 There is growing risk the market will enter a situation where positive returns will not be possible unless investments are made for longer term. If this were to happen, the investment strategy of the Authority would shift focus onto minimising costs albeit maintaining security and liquidity of cash.

End of Transition Period

- 2.6 The end of the transition period on the 31st of December 2020 poses additional cash liquidity risk in the market. Officers are continuing to monitor the changing environment and will look to pursue an investment and debt strategy which minimises the risk to the Authority.

3. THE GMCA'S PORTFOLIO POSITION AS AT 30th SEPTEMBER 2020

- 3.1 The approved Treasury Management Strategy for 2020-21 forecast a borrowing requirement of £163.6m for permanent borrowing in 2020-21 to fund the capital programme. It was noted in the reports that should some of the forecast cash flows alter in scale or timing the requirement might be materially different.
- 3.2 Cash balances during the first six months of 2020-21 remained relatively high and no borrowing was required in this period. The Authority has faced some exceptional

circumstances during COVID-19, which is expected to put additional pressure on the need to borrow in the second half of the year.

3.3 The GMCA's debt position at the beginning and at the end of September 2020 was as follows:

	31st March 2020		30th September 2020	
	Principal £m	Average Rate %	Principal £m	Average Rate %
PWLB	583.4	4.51	569.5	4.54
EIB	581.9	3.64	576.4	3.64
Market	105.0	4.20	105.0	4.20
Temporary	80.0	0.68	0.0	0.00
TfGM	10.7	0.00	66.7	0.00
	1,361.0	3.85	1,317.6	3.89
Housing Invest. Fund HIF	181.3	0.00	181.3	0.00
Housing Comm. Agency HCA	29.2	0.00	29.2	0.00
Gross debt	1,571.5	3.34	1,528.1	3.35
Deposits	(58.9)	0.24	(291.6)	0.07
Gross investments	(58.9)	0.24	(291.6)	0.07

- 3.4 When reviewing the table above it is important to note that the temporary borrowing and deposit figures fluctuate daily to meet the daily cash flow requirements of the Authority. The temporary figures in the table above are therefore only a snapshot at a particular point in time.
- 3.5 Total gross debt has decreased by £43.4m in the first six months of 2020-21. The details of these changes are described below.
- 3.6 PWLB funding decreased by £13.9m. This was as a result of a £5.0m loan maturity on the 7th of May 2020 as well as a £1.9m loan on the 10th of August 2020. The remaining £7.0m decrease was due to principal repayments under the annuity debt structures.
- 3.7 EIB funding of £5.5m was also repaid in the first half of the year in the form of principal repayments as part of the annuity debt structures.
- 3.8 Temporary borrowing of £80.0m carried forward was repaid by the end of May 2020 reflecting the strong cash position in the first half of the year. No further temporary borrowing was required.
- 3.9 The Authority has pooling arrangements in place with Transport for Greater Manchester (TfGM) where the surplus funds are invested alongside GMCA's surplus. The TfGM balance has increased by £56.0m since the beginning of the financial year.

3.10 The Authority has the statutory powers necessary to operate the Greater Manchester Housing Investment Loan Fund (GMHILF) and the City Deal Receipts from the Homes and Communities Agency (HCA). The total outstanding balance remains at £210.5m on the 30th of September 2020.

4 REVIEW OF ECONOMIC CONDITIONS 2020-21

4.1 The Bank of England maintained the lending rate at 0.10% in the first half of the financial year. In March 2020 the Bank of England dropped the key lending rate initially from 0.75% to 0.25% followed by a further reduction to 0.10% on the 19th of March 2020 in efforts to stimulate the economy during Covid-19.

4.2 Appendix C provides a more detailed review of the economic situation.

5. PUBLIC WORK LOANS BOARD (PWLB) CONSULTATION

5.1 As noted in the 2019/20 Outturn Report, the PWLB changed its policy to increase the margin on Gilts to Gilts plus 200 basis points and therefore the margin on the Certainty Rate, which local authorities can apply for, to Gilts plus 180 basis points. This means that forecast interest costs on future debt increased substantially, though remained below the level budgeted for. Interest rates on PWLB debt the Authority already hold have not changed.

5.2 The government launched a consultation to work with local authorities to develop a targeted intervention to stop ‘debt-for-yield’ activity while protecting the crucial work the local authorities perform on service delivery, housing and regeneration. When announcing the consultation government suggested that the intention is that if PWLB borrowing for ‘debt-for-yield’ activity can be curtailed they would look to reduce the margin on PWLB interest rates above Gilts, which currently stands at 2.00%. The consultation was intended to finish in early June, but due to Covid-19 it was extended until the end of July. The outcome of the consultation is being awaited as it will determine the scale of the future debt costs the Authority may face.

6. EXTERNAL BORROWING IN 2020-21

6.1 GMCA continues to be on the approved list of authorities that can access the PWLB Certainty Rate, giving the Authority access to a 20 basis points reduction on the published PWLB rates.

6.2 PWLB interest rates have fluctuated during the first half of the year as shown in the summary table on the next page and in the graph on Appendix A.

PWLB Standard Borrowing Rates 2020-21 to date for 1 to 50 years					
	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.90%	1.87%	2.11%	2.60%	2.33%

Date	18/09/2020	30/07/2020	31/07/2020	18/06/2020	24/04/2020
High	2.14%	2.19%	2.39%	3.00%	2.85%
Date	08/04/2020	08/04/2020	08/04/2020	28/08/2020	28/08/2020
Average	2.00%	2.00%	2.24%	2.74%	2.53%

6.3 Carried forward temporary borrowing of £80.0m used to ensure both liquidity during the start of the Covid-19 Pandemic was repaid in the first half of the year as cash balances increased.

6.4 Current cash flow forecast suggests the need for additional borrowing by the end of the financial year 2020-21. Officers are monitoring both short and longer term debt options.

7. COMPLIANCE WITH PRUDENTIAL INDICATORS AND TREASURY LIMITS

7.1 The Authority operated within the prudential indicators and treasury limits set out in the Treasury Management Strategy Statement on 29th May 2020. Performance against these targets is shown in Appendix B.

8. INVESTMENT STRATEGY FOR 2020-21 TO DATE

8.1 A revised Treasury Management Strategy Statement (TMSS) for 2020-21 was approved by the Authority on the 29th of May 2020. The GMCA's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Authority's investment priorities as the security of capital and liquidity of investments.

8.2 The Authority's temporary cash balances are managed by the Manchester City Council's Treasury Management team and are invested with those institutions listed in the Authority's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy and the approved limits were not breached in 2020-21.

9. TEMPORARY BORROWING AND INVESTMENT OUTTURN FOR 2020-21 TO DATE

9.1 Investment rates available in the market continue to be at an historical low point. The average level of funds available for investment purposes in the first six months of 2020-21 was just over £232.9m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of levy receipts, receipt of grants, and progress on the capital programme.

9.2 As shown below, the Authority's return was higher than the benchmark return. The relatively high level of cash balances held by the Authority has provided an opportunity to optimise the number of investments with other local authorities and Money Market Funds (MMFs), returning a higher level of yield.

	Average temporary Investment/ borrowing	Net Return/Cost	Benchmark Return / Cost
Temporary Investments	£232.9m	0.13%	-0.06%*
Temporary Borrowing	£21.0m	0.67%	0.45%**

* Average 7-day LIBID rate

** Average 12-month LIBOR rate

9.3 Due to the timing difference of when the temporary borrowing was taken and the varying terms, the cost was higher than that of the benchmark. Taking into account these varying factors, value for money was achieved.

9.4 None of the institutions in which investments were made, such as banks, local authorities and MMFs, showed any difficulty in repaying investments and interest during the year. The list of institutions in which the Authority invests is kept under continuous review.

10. CONCLUSION

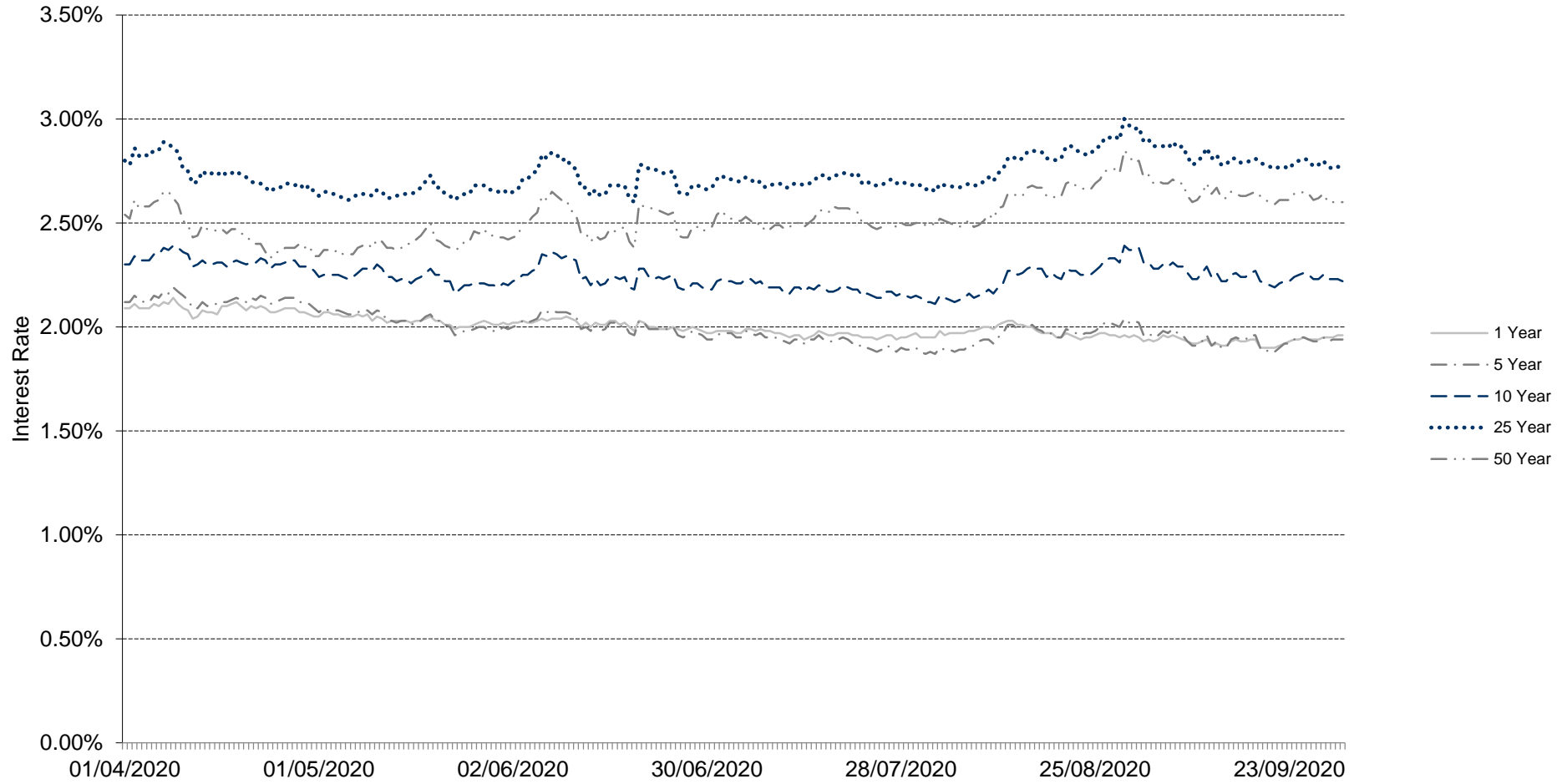
10.1 At the start of the Covid-19 Pandemic, the Authority faced significant liquidity pressure on the cash flow. Carried forward temporary borrowing at the end of the year 2019-20 was repaid by the end of May 2020 as cash balances improved. Further borrowing is likely to be required in the next half of the financial year.

10.2 Cash resources have increased following the start of the financial year 2020-21. Therefore, the current borrowing position reflects the strong balance sheet of the Authority.

10.3 The Authority exceeded the benchmark rate of return on temporary investments during the 2020-21 financial year. Work will continue to review all investment options, to see if a greater rate of return could be attracted without compromising the Authority's strong risk management position.

10.4 The change in policy for the PWLB has challenged the local authority debt environment, and it is anticipated that it will take some time before PWLB formally replies to the consultation that finished at the end of July 2020. Officers will continue monitoring the market, and engage with market participants including banks, investment firms, brokers and advisors to review the debt opportunities available to the Authority.

**Appendix A –
PWLB Interest**



APPENDIX B

TREASURY MANAGEMENT PRUDENTIAL INDICATORS: APRIL – SEPT. 2020

	Original	Minimum In	Maximum In
	£m	Year	Year
		£m	£m
Operational Boundary for External Debt:			
Borrowing	£2,427.2	£1,461.3	£1,560.5
Other Long Term Liabilities	£50.0	£48.7	£50.3
Authorised Limit for External Debt:			
Borrowing	£2,542.8	£1,461.3	£1,560.5
Other Long Term Liabilities	£52.4	£48.7	£50.3
	Original	Actual as at 30th Sept. 2020	
Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

	Lower Limit	Upper Limit	
	2020-21	2020-21	Actual as at
	Original	Original	30th Sept. 2020
Maturity structure of Fixed Rate Borrowing			
under 12 months	0%	50%	1.5%
12 months and within 24 months	0%	50%	3.0%
24 months and within 5 years	0%	50%	14.5%
5 years and within 10 years	0%	50%	18.9%
10 years and above	0%	100%	62.1%

REVIEW OF ECONOMIC CONDITIONS FOR FIRST SIX MONTHS OF 2020-21 AND FUTURE OUTLOOK

This section has been prepared by the Authority's Treasury Advisors, Link Asset Services, for the 30th of September 2020 and includes their forecast for future interest rates after the PWLB policy change referenced in the report.

1 ECONOMIC PERFORMANCE TO DATE 2020-21

1.1 The Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in GDP in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the unemployment rate was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI inflation to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

1.2 It also squashed any idea of using negative interest rates, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be “less effective as a tool to stimulate the economy” at this time when banks are worried about future loan losses. It also has “other instruments available”, including quantitative easing (QE) and the use of forward guidance.

1.3 The MPC expected the £300bn of QE purchases announced between its March and June meetings to continue until the “turn of the year”. This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.

1.4 In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the “medium-term projections were a less informative guide than usual” and the minutes had multiple references to downside risks, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial

generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1st November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid-September.

- 1.5 Overall, the pace of recovery is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.
- 1.6 There will be some painful longer term adjustments as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.
- 1.7 One key addition to the Bank's forward guidance was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate
- 1.8 The Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.
- 1.9 US. The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked its inflation target from 2% to maintaining an average of 2% over an unspecified time period i.e. following periods when

inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary “trap” like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC’s updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- 1.10 EU. The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.
- 1.11 China. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.
- 1.12 Japan. There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.
- 1.13 World growth. Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

2 INTEREST RATE FORECAST

The Authority's treasury advisor, Link Group, provided the following forecasts on 11th August 2020 (PWLB rates are certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20										
	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

- 2.1 Additional notes by Link on this forecast table: -
- 2.2 Please note that we have made a slight change to our interest rate forecasts table above for forecasts for 3, 6 and 12 months. Traditionally, we have used LIBID forecasts, with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that all LIBOR rates up to 6 months are currently running below 0.1%, using that convention would give negative figures as forecasts for those periods. However, the liquidity premium that is still in evidence at the short end of the curve, means that the rates actually being achieved by local authority investors are still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 0.05% is achievable for 3 months, 0.1% for 6 months and 0.15% for 12 months.
- 2.3 During 2021, Link will be continuing to look at market developments in this area and will monitor these with a view to communicating with clients when full financial market agreement is reached on how to replace LIBOR. This is likely to be an iteration of the overnight SONIA rate and the use of compounded rates and Overnight Index Swap (OIS) rates for forecasting purposes.
- 2.4 If clients require forecasts for 3 months to 12 months beyond the end of 2021, a temporary fix would be to assume no change in our current forecasts.
- 2.5 The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6th August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

3 GILT YIELD / 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 last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

- 3.1 Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been 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 close of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.
- 3.2 From the local authority borrowing perspective, HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

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

- PWLB Standard Rate is gilt plus 200 basis points (G+200bps)
- PWLB Certainty Rate is gilt plus 180 basis points (G+180bps)
- 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)

3.4 It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

3.5 As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

4 THE BALANCE OF RISKS TO THE UK

4.1 The overall balance of risks to economic growth in the UK is probably relatively even but is subject to major uncertainty due to the virus.

4.2 There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

- UK - second nationwide wave of virus infections requiring a national lockdown
- UK / EU trade negotiations – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.
- UK - Bank of England takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the Eurozone sovereign debt crisis. 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 recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, 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 extent of credit losses resultant of the pandemic.
- German minority government & general election in 2021. In the German general election of September 2017, Angela Merkel’s CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- Other minority EU governments. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- Austria, the Czech Republic, Poland and Hungary now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- Geopolitical risks, for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- US – the Presidential election in 2020: this could have repercussions for the US economy and SINO-US trade relations.

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

- UK - stronger than currently expected recovery in UK economy.
- Post-Brexit – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Counterparty – one of the opposing parties involved in a borrowing or investment transaction

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

LIBID (London Interbank Bid Rate) – This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) – This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) – This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market - The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Authority vulnerable to current interest rates in that year.

Monetary Policy Committee – the independent body that determines Bank Rate.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Authority to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Authority's capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government's Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more than one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day, or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.