GMCA GREATER MANCHESTER COMBINED AUTHORITY

Date:	**27th August 2021**
Subject:	**Treasury Management Outturn 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 2020/21 financial year.

RECOMMENDATIONS:

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

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BACKGROUND PAPERS:

- GMCA Treasury Management Strategy Statement, Borrowing Limits and Annual Investment Strategy 2020/21, Audit Committee 21st January 2020.
  GMCA Interim Treasury Management Report 2020/21, Audit Committee 20th November 2020.

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 Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in Local Authorities (the Code). 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 27 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 interim Treasury Management report received by the Audit Committee of the GMCA on the 27 November 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 Considerations Update
Section 3: The Authority’s Portfolio Position as at 31 March 2021
Section 4: Review of Economic Conditions 2020/21
Section 5: Public Works Loans Board (PWLB) Consultation
Section 6: External Borrowing for 2020/21
Section 7: Compliance with Prudential Indicators and Treasury Limits
Section 8: Investment Strategy for 2020/21
Section 9: Temporary Borrowing and Investment Outturn for 2020/21
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

Outstanding considerations which have been presented to the Audit Committee on 20th November 2020, are detailed below:

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

2.1 European Investment Bank (EIB)

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.

2.2 Lender Option Borrower Options (LOBOs)

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.

2.3 Negative Rates

In February 2021, the Bank of England made clear it did not intend to set a negative bank rate, however it asked firms to be ready for the implementation of negative rates as it remains a viable option of its Monetary Policy Toolkit. No investments at a negative rate were undertaken in 2020/21.

There is still a risk the market will enter an environment where the conditions do not allow for a positive return in the short 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. Officers are continuing to assess the impact negative rates could have on the Authority's debt and investment strategies.

3 THE GMCA's PORTFOLIO POSITION AS AT 31 MARCH 2021

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 year remained relatively high and no new borrowing was required. The Authority continues to face exceptional circumstances during COVID-19, which is expected to put additional longer term pressure on the need to borrow in the next financial year.

3.3 The GMCA’s debt position at the beginning and end of year was as follows:

		31st March 2020		**31st March 2021**	
		Principal £m	Average Rate %	Principal £m	Average Rate %
PWLB		583.4	4.51	562.5	4.57
EIB		581.9	3.64	570.7	3.63
Market		105.0	4.20	105.0	4.20
Temporary		80.0	0.68	0.0	0.00
TfGM		10.7	0.00	61.8	0.00
		1,361.0	**3.85**	**1,300.0**	**3.91**
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**	**1,510.5**	**3.37**
Deposits		(58.9)	0.24	(139.4)	0.05
Net Debt		**1,512.6**	**-**	**1,371.1**	**-**

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 £61m throughout the financial year 2020/21. The details of these changes are described below.

3.6 PWLB funding decreased by £20.9m throughout the year. This was as a result of a £5m loan maturity on the 7 May 2020 as well as a £1.9m loan on the 10 August 2020. The remaining £14m decrease was due to principal repayments under the annuity debt structure arrangements.

3.7 EIB funding of £11.2m 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 £80m carried forward was repaid by the end of May 2020. 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 £51.1m 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 31 March 2021.

4 REVIEW OF ECONOMIC CONDITIONS 2020/21

4.1 The Bank of England maintained the lending rate at 0.10% throughout the financial year since March 2020 when the key lending rate was dropped initially from 0.75% to 0.25% followed by a further reduction to 0.10% on the 19 March 2020.

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

5 PUBLIC WORK LOANS BOARD (PWLB) CONSULTATION

5.1 As originally reported in the previous Outturn Report 2019/20, 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 authorities can apply for, to Gilts plus 180 basis points. The government launched a consultation to work with authorities to develop a targeted intervention to stop 'debt-for-yield' activity while protecting the crucial work the authorities perform on service delivery, housing, and regeneration.

5.2 Following the consultation, on 26 November 2020, the rates have reversed back to Gilts plus 100 basis points with additional requirements. Each authority that wishes to borrow from the PWLB is required to submit a high-level description of their capital spending and financing plans for the following three years, including their expected use of the PWLB. Any investment assets bought primarily for yield will not be supported by PWLB and could lead to access to the PWLB being limited to refinancing existing debt only.

Authorities are asked to:

i. Categorise Capital Spending into: Service Spending, Housing, Regeneration, Preventative Action, Treasury Management, and Debt for Yield activity.

ii. Provide a short description covering at least 75% of the spending in each category.

iii. Provide assurance from the section 151 officer or equivalent that the Authority is not borrowing in advance of need and does not intend to buy investment assets primarily for yield.

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 year as shown in the summary table below and in the graph on Appendix A.

Published PWLB Borrowing Rates 2020/21 for 1 to 50 years					
	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**

Low	0.85%	0.92%	1.20%	1.73%	1.52%
Date	04/01/2021	14/12/2020	11/12/2020	11/12/2020	11/12/2020
High	2.14%	2.19%	2.48%	3.06%	2.91%
Date	08/04/2020	08/04/2020	11/11/2020	11/11/2020	11/11/2020
Average	1.63%	1.70%	2.01%	2.53%	2.34%

6.3 No additional new borrowing was taken in 2020/21.Current cash flow forecast suggests the need for additional borrowing by the end of the next financial year 2021/22. Officers continue to monitor both the short and long term debt options.

7. COMPLIANCE WITH PRUDENTIAL INDICATORS AND TREASURY LIMITS

7.1 The Authority operated within the prudential indicators outlined in the Treasury Management Strategy Statement. Performance against these targets is shown in Appendix B.

8. INVESTMENT STRATEGY FOR 2020/21

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

8.2 The Authority's temporary cash balances are managed by 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

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 2020/21 was just over £215.5m. 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.

9.3 The temporary borrowing portfolio consisted of loans which were carried forward from the previous financial year and matured before the end of May 2020. The average benchmark return from the start of the financial year to the date when the temporary borrowing was repaid equated to 0.79%. The average benchmark rate continued to decrease throughout the remainder of the financial year resulting with an average of 0.29% as shown in the table below.

	Average temporary Investment/ borrowing	Net Return/Cost	Benchmark Return / Cost
Temporary Investments	£215.5	0.09%	-0.07 %*
Temporary Borrowing	£5.3m	0.66%	0.29%**

** Yearly average 7-day LIBID rate sourced from Link*

*** Yearly average 12-month LIBOR rate sourced from Link*

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

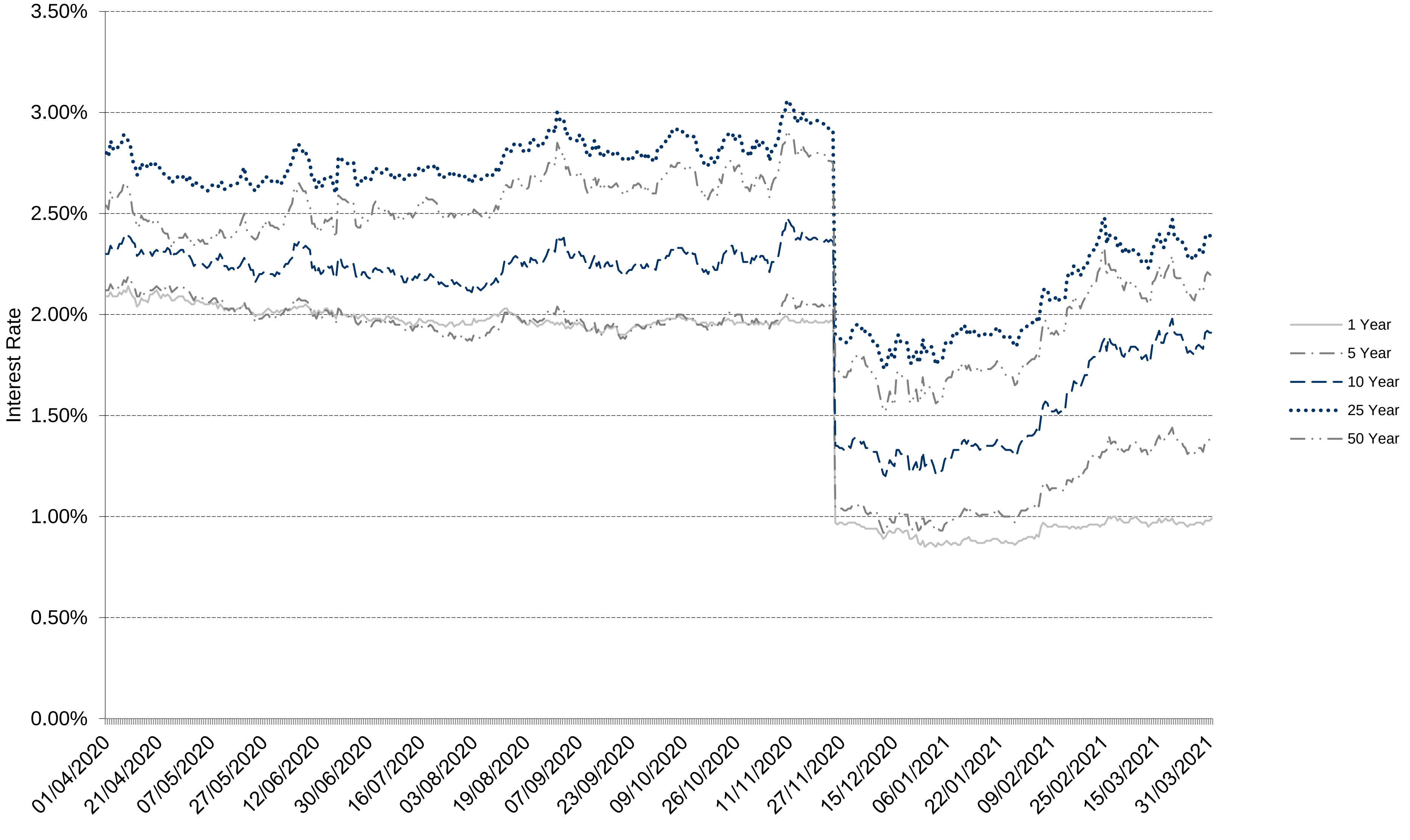
10.1 Carried forward temporary borrowing to help with the liquidity pressures the Authority faced at the start of the Covid-19 Pandemic, has been repaid. No additional temporary borrowing was required in 2020/21. Cash resources have increased at the start of the financial year and remained relatively high throughout the year reflecting the strong balance sheet position.

10.2 The Authority exceeded the benchmark rate of return on temporary investments during the 2020/21. 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.

10.3 In the second half of the year, the Authority welcomed the conclusion of the PWLB consultation where additional requirements were introduced, and the rates were reversed by 100bps as outlined in section 5.

10.4 The Authority is likely to face challenging market conditions in the coming years, resulting from long term Covid-19 implications, end of UK’s transition period after Brexit, and the possibility that market rates will go negative. These factors are likely to have a negative impact on the costs and income resulting with further cash flow instability. Officers will continue monitoring the market, and engage with market participants including banks, investment firms, brokers and advisors to review the investment and debt opportunities available to the Authority.

Appendix A – PWLB Interest Rates 2020/21



APPENDIX B

TREASURY MANAGEMENT PRUDENTIAL INDICATORS: 2020/21

	Original £m	Minimum In Year £m	Maximum In Year £m
Operational Boundary for External Debt:			
Borrowing	2,477.3	1,448.7	1,560.5
Other Long Term Liabilities	50.0	44.4	47.7
Authorised Limit for External Debt:			
Borrowing	2,595.3	1,448.7	1,560.5
Other Long Term Liabilities	52.4	44.4	47.7
	Original	**Actual as at 31 March 2021**	
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	
Maturity structure of Fixed Rate Borrowing	**2020/21 Original**	**2020/21 Original**	**Actual as at 31 March 2021**
under 12 months	0%	50%	1%
12 months and within 24 months	0%	50%	3%
24 months and within 5 years	0%	50%	15%
5 years and within 10 years	0%	50%	19 %
10 years and above	0%	100%	62%

Appendix C

REVIEW OF ECONOMIC CONDITIONS FROM APRIL 2020 TO MARCH 2021 AND FUTURE OUTLOOK

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

1. Economics update 31.03.2021

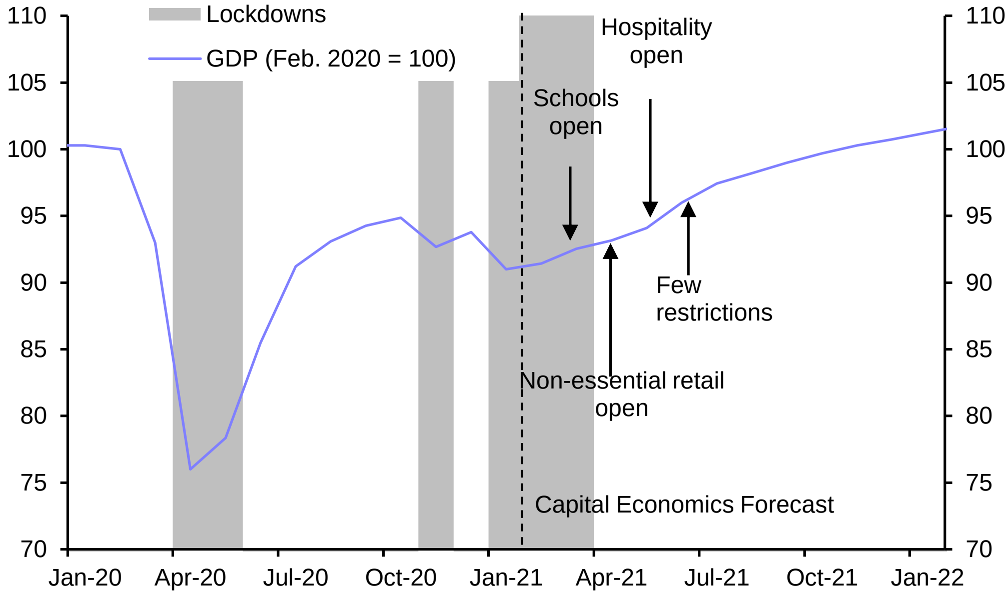
UK. The key quarterly Monetary Policy Report meeting of the Bank of England's Monetary Policy Committee kept **Bank Rate** and quantitative easing (QE) unchanged on 4th February, (as it also did at its 18th March meeting). However, it revised its economic forecasts to take account of a third national lockdown which started on 5th January, which is going to further delay economic recovery and do further damage to the economy. Although its short-term forecasts were cut for 2021 due to the start of a third lockdown in early January, the medium-term forecasts were more optimistic than in November, based on an assumption that the current lockdown will be gradually eased after Q1 as vaccines are gradually rolled out and life can then start to go back to some sort of normality. The Bank's main assumptions were:

- The economy would start to recover strongly from Q3 2021 although it acknowledged there were downside risks from virus mutations etc.
- £125bn of savings made by consumers during the pandemic will give a big boost to the pace of economic recovery once lockdown restrictions are eased and consumers can resume high street shopping, going to pubs and restaurants and taking holidays.
- The economy would still recover to reach its pre-pandemic level by Q1 2022 despite a long lockdown in Q1 2021. **Spare capacity** in the economy would be eliminated in Q1 2022 and there would be **excess demand** in the economy by Q4 2022.
- **CPI inflation** was forecast to rise quite sharply towards the 2% target in the first half of 2021 due to some temporary factors, (e.g. the reduction in VAT for certain services comes to an end) and given developments in energy prices. CPI inflation was projected to be close to 2% in 2022 and 2023.
- The MPC reiterated its previous guidance that Bank Rate would not rise until inflation was sustainably above 2%. This means that it will tolerate inflation running above 2% from time to time to balance out periods during which inflation is below 2%. This is termed **average inflation targeting.** While financial markets are pricing in Bank Rate starting to rise by the end of 2022, this policy could mean that Bank Rate does not rise until as late as 2026.
- The Bank of England removed **negative interest rates** as a possibility for at least six months as financial institutions were not ready to implement them. As in six months' time the economy should be starting to grow strongly, this effectively means that negative rates occurring were unlikely during the current downturn. (**Gilt yields and PWLB rates** jumped upwards after the removal of negative rates as a key risk in the short-term.)

There are two views in respect of Bank Rate beyond our three-year time horizon:

a. The MPC will be keen to raise Bank Rate as soon as possible in order for it to be a usable tool when the next economic downturn comes along. This is in line with thinking on Bank Rate over the last 20 years; financial markets are currently pricing in Bank Rate starting to rise by the end of 2022.

b. Conversely, that we need to adjust to the new post-pandemic era that we are now in. In this new era, **the shift to average inflation targeting** has set a high bar for raising Bank Rate i.e. only when inflation has demonstrated that it has risen sustainably above 2%. In addition, many governments around the world have been saddled with high levels of debt. When central bank rates are low, and below the average GDP growth rate, the debt to GDP ratio will gradually fall each year without having to use fiscal tools such as raising taxes or austerity programmes, (which would depress economic growth and recovery). This could therefore result in governments revising the setting of mandates to their national central banks to allow a higher rate of inflation linked to other economic targets. This is the Capital Economics view – that Bank Rate will not rise for the next five years and could then struggle to get to 1% within 10 years.



- **COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the second half of 2021** after a third wave of the virus threatened to overwhelm hospitals around the start of the year. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in the still-depressed sectors like restaurants, travel and hotels. The UK has made fast progress with giving a first jab to half of all adults and this programme should be completed in the second half of the year. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly can vaccines be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

- **The Budget on 3rd March** increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank's policy mandate to allow for a higher target for inflation.

- **Brexit.** The final agreement on 24th December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.

- **US.** The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a $1.9trn (8.8% of GDP) stimulus package in March on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a $2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was 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, (and this year), 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. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth this year to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping treasury yields at historically low levels – **which will also have an influence on gilt yields in this country.**

- **EU.** Both the roll out and take up of vaccines has been disappointingly slow in the EU, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.

- Inflation is likely to rise sharply to around 2% during 2021 for a short period, but as this will be transitory due to one-off factors, it will cause **the ECB** little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, **unlikely to be a euro crisis** while the ECB is able to maintain this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 20/21, growth is likely to be tepid in 21/22.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That is huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP in 2020/21. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum, the government's latest fiscal effort should help to ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

- **Impact on gilt yields and PWLB rates in 2021.** Since the start of 2021 gilt yields and PWLB rates have risen sharply. What has unsettled financial markets has been a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic, in addition to the $900bn support package passed in December. Financial markets have been alarmed that the two packages could cause an excess of demand in the economy which could **unleash inflationary pressures** and force the FOMC to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years.

- A further concern in financial markets is **when will the Fed end quantitative easing (QE) purchases of treasuries** and how they will gradually wind it down. These ongoing monthly purchases are currently acting as downward pressure on treasury yields. Nonetheless, during late February and in March, yields rose sharply. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards there will invariably impact and influence financial markets in other countries. It is noticeable that gilt yields moved higher after the MPC meeting in early February as a result of both developments in the US, and financial markets also expecting a **similarly rapid recovery of the UK economy as in the US;** both countries were expected to make similarly rapid progress with vaccinating their citizens and easing Covid restrictions. They are therefore, expecting inflation to also increase more quickly in the UK and cause the MPC to respond by raising Bank Rate more quickly than had previously been expected.

- **Deglobalisation.** Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products and vice versa. This is likely to reduce world growth rates.

- **Central banks' monetary policy.** During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

2. Interest rate forecasts

The Authority has appointed Link Group as its treasury advisor and part of their service is to assist the Authority to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate 8.3.21												
	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.20	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.40	1.40	1.40	1.40
10 yr PWLB	1.60	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	1.90
25 yr PWLB	2.10	2.10	2.20	2.30	2.30	2.30	2.40	2.40	2.50	2.50	2.50	2.50
50 yr PWLB	1.90	1.90	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

Additional notes by Link on this forecast table: -

- *LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*
- *We will maintain continuity by providing clients with LIBID investment benchmark rates on the current basis.*

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings, although some forecasters had suggested that a cut into negative territory could happen. However, the minutes of the Monetary Policy Committee in February 2021 made it clear that commercial banks could not implement negative rates within six months, and by that time the economy would be expected to be recovering strongly and so there would be no requirement for negative rates. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2024.

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

Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020. After gilt yields initially spiked upwards in March, yields fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March, and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply.

As at 31st December 2020, all gilt yields from 1 to 8 years were still in negative territory: however, since then all gilt yields have now become positive and have risen sharply, especially medium and longer-term yields.

- 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 non-HRA capital schemes. A consultation was then held with local authorities and **on 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates;** the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

  - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
  - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
  - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
  - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
  - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

As the interest forecast table for PWLB certainty rates, (gilts plus 80bps), above shows, there is likely to be little upward movement in PWLB rates over the next three years as the Bank of England is not expected to raise Bank Rate during that period as inflation is not expected to be sustainably over 2%.

APPENDIX D

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.