WARWICK DISTRICT COUNCIL

Agenda Item 8

**Executive**
**Date of meeting: 11th February 2021**

**Title:** Treasury Management Strategy 2021/22
**Lead Officer:** Richard Wilson, Principal Accountant (Capital & Treasury) 01926 456801 or email richard.wilson@warwickdc.gov.uk
**Portfolio Holder:** Cllr Richard Hales
**Public report / Confidential report** Public – not confidential
**Wards of the District directly affected:** All

Contrary to the policy framework: No
Contrary to the budgetary framework: No
Key Decision: Yes
Included within the Forward Plan: Yes Ref # 1167
Equality Impact Assessment Undertaken: No - not relevant
Consultation & Community Engagement:
Final Decision: No
Accessibility checked: Yes

**Officer/Councillor Approval**

| Officer Approval | Date | Name |
|---|---|---|
| Chief Executive/Deputy Chief Executive | 19/1/21 | Andrew Jones |
| Head of Service | 15/1/21 | Mike Snow |
| CMT | 19/1/21 | |
| Section 151 Officer | 15/1/21 | Mike Snow |
| Monitoring Officer | 19/1/21 | Andrew Jones |
| Finance | 14/1/21 | Richard Wilson |
| Portfolio Holder(s) | 18/1/21 | Cllr Richard Hales |

## 1. Summary

1.1. This report details the strategy that the Council will follow in carrying out its treasury management activities in 2021/22.

## 2. Recommendation

2.1. That the Executive recommends to Council:

a) The Treasury Management Strategy for 2021/22 as outlined in paragraph 3.3 and contained in Appendix A,

b) The 2021/22 Annual Investment Strategy as outlined in paragraphs 3.4 and contained in Appendix B.

c) The Minimum Revenue Provision Policy Statement as outlined in paragraph 3.5 and contained in paragraphs 5.1 to 5.5 of Appendix C.

d) The Prudential Indicators as outlined in paragraph 3.6 and contained in Appendix D, including the amount of long-term borrowing required for planned capital expenditure.

## 3. Reasons for the Recommendations

3.1. The Council's treasury management operations are governed by various Treasury Management Practices (TMPs) that the CIPFA Treasury Management Code requires be produced by the Council and adhered to by those officers engaged in the treasury management function. These TMPs have previously been reported to the Executive and are subject to periodic Internal Audit review.

3.2. There have been no changes to the TMPs in this cycle.

3.3. Under CIPFA's updated *Treasury Management in Public Services Code of Practice* the Council continues to be required to have an approved annual *Treasury Management Strategy*, under which its treasury management operations can be carried out. The proposed Strategy for 2021/22 is included as Appendix A.

3.4. This Council has regard to the Government's Guidance on Local Government Investments. The guidance states that an *Annual Investment Strategy* must be produced in advance of the year to which it relates and must be approved by the full Council. The Strategy can be amended at any time and it must be made available to the public. The *Annual Investment Strategy* for 2021/22 is shown as Appendix B.

3.5. The Council has to make provision for the repayment of its outstanding long-term debt and other forms of long-term borrowing such as finance leases. Statutory guidance issued by MHCLG requires that a statement on the Council's *Minimum Revenue Provision (MRP) Policy* should be submitted to full Council for approval before the start of the relevant financial year. This is contained in Appendix C.

3.6. The *Prudential Code for Capital Finance in Local Authorities* was last revised in 2018 and introduced new requirements for the way that capital spending plans are considered and approved, in conjunction with the development of an integrated Treasury Management Strategy. The Prudential Code requires full Council to approve a number of Prudential Indicators, including amounts of borrowing required to support capital expenditure, set out in Appendix D, which must be considered when determining the Council's Treasury Management Strategy for a minimum of the next three financial years.

3.7. The Executive previously requested that the 2020/21 Treasury Management Strategy Statement considered the policy of investing in fossil fuels. The investments which at times the Council may have some exposure to fossil fuel extraction companies are the two corporate equity funds, operational since 2017/18.

3.8. Due to being 'pooled funds', the Council is unable to directly or influence where the fund managers place these investments, and currently around 5% of the pooled funds are in 'fossil fuel' companies. Therefore, the recommendation has previously been made to divest from these two funds no later than the end of 2025. However, officers continue to monitor the situation and seek to identify suitable opportunities to divest as the most financially beneficial time for the Council. Further details on the amount by which the funds would have to increase to avoid a capital loss on disposal, which would be chargeable to the General Fund, are included in Appendix A, paragraph 9.3. Subject to the immediate financial needs of the Council, which may necessitate the managed closing of these investments, this money could then be re-invested in non-carbon or ESG equity funds, or alternative investments in-line with the Investment Strategy. Further information is included within this report.

## 4. Policy Framework

### 4.1. Fit For the Future (FFF)

4.1.1. The Council's FFF Strategy is designed to deliver the Vision for the District of making it a Great Place to Live, Work and Visit. To that end amongst other things the FFF Strategy contains several Key projects. This report shows the way forward for implementing a significant part of one of the Council's Key projects.

4.1.2. The FFF Strategy has three strands – People, Services and Money and each has an external and internal element to it, the details of which can be found on the Council's website The table below illustrates the impact of this proposal if any in relation to the Council's FFF Strategy.

### 4.2. FFF Strands

#### 4.2.1. External impacts of proposals

The Treasury Management function is an underpinning activity that enables the Council to meet its vision by maximising investment returns and minimising borrowing costs, while managing the risk to the Council's funds and maintaining liquidity, so that the Council can meet its financial obligations through a well-managed cash flow. This protects services and benefits the Council's customers and other stakeholders.

**People - Health, Homes, Communities** – Treasury Management indirectly enables financial resources to be ready for the Council to meet the following intended outcomes: Improved health for all; Housing needs for all met; Impressive cultural and sports activities; Cohesive and active communities.

**Services - Green, Clean, Safe** – Treasury Management is a support function towards to overall achievement of the Council's intended outcomes: Becoming a net-zero carbon organisation by 2025; Total carbon emissions within Warwick District are as close to zero as possible by 2030; Area has well looked after public spaces; All communities have access to decent open space; Improved air quality; Low levels of crime and ASB. In terms of becoming a net-zero carbon organisation, the Council aims to disinvest the equity funds from any carbon-related organisations at the earliest opportunity – and no later than the end of 2025 - that the current economic conditions allow, and seek new 'green' investment opportunities that meet the overarching Treasury Management framework that the Council must operate within.

**Money - Infrastructure, Enterprise, Employment** – Treasury Management is a fundamental part of effective money management and indirectly aids the following intended outcomes: Dynamic and diverse local economy; Vibrant town centres; Improved performance/productivity of local economy; Increased employment and income levels.

4.2.2. **Internal impacts of the proposals**

The Treasury Management function enables the Council to meet its vision, primarily through having suitably qualified and experienced staff deliver the service in accordance with the Council's Treasury Management Practices and the national framework that local government operates.

**People - Effective Staff –**All staff are properly trained; All staff have the appropriate tools; All staff are engaged, empowered and supported and that the right people are in the right job with the right skills and right behaviours. Staff have access to the Council's treasury management advisers, the Link Group, who provide additional support and training to staff and members.

**Services - Maintain or Improve Services** – Treasury Management indirectly helps with the following intended outcomes: Focusing on our customers' needs; Continuously improve our processes and Increase the digital provision of services.

**Money - Firm Financial Footing over the Longer Term** - Treasury Management is a fundamental part of effective both short and long term money management and indirectly aids the following intended outcomes: Better return/use of our assets; Full Cost accounting; Continued cost management; Maximise income earning opportunities and Seek best value for money.

4.3 **Supporting Strategies**

4.3.1. Each strand of the FFF Strategy has a number of supporting Strategies. The Treasury Management function is consistent with the relevant supporting strategies. Following the Treasury Management principles of Security, Liquidity and Yield (SLY) maximises financial stability in order for the Council to operate effectively.

4.3. **Changes to Existing Policies**

The Treasury Management function is in accordance with existing policies from 2020/21, including the recommendation to divest from direct ownership of fossil fuels companies or commingled funds that include fossil fuel public equities and corporate bonds by no later than 2025, in pursuance of the Council's Climate Emergency Declaration.

4.4. During 2021/22, the Council will produce the timeline for the production of a *Investment Regeneration Strategy*, to cover non-treasury investments, which may have an impact on the Council's use of non-specified investments at some point in the future.

4.5. **Impact Assessments**

There are no impacts of new or significant policy changes proposed in respect of equalities.

## 5. Budgetary Framework

5.1. The Treasury Management Strategy has a significant impact on the Council's budget through its objective of maximising investment income and minimising interest payable whilst ensuring the security and liquidity of financial resources.

5.2. The 2021/22 budget for investment income, after inclusion of growth items, is as follows:

| | **20/21 Revised budget £'000** | **21/22 Original budget £'000** |
|---|---|---|
| External investment income | 433.6 | 397.8 |
| Deferred capital receipts interest | 16.8 | 13.7 |
| Long-term debtor loans | 151.3 | 237.5 |
| *less* : HRA allocation | -154.5 | -123.2 |
| Net interest to General Fund | 447.2 | 525.8 |

5.3. Divesting from the current two equity funds with the subsequent re-procurement of suitable alternative funds, if this option is viable, will incur an additional cost. Any costs will be included in a future budget report, before a re-procurement.

## 6. Risk Management

6.1. Investing the Council's funds inevitably creates risk and the Treasury Management function effectively manages this risk through the application of the SLY principle. Security (S) ranks uppermost, followed by Liquidity (L) and finally Yield (Y). Social impact will be an underlining principle. It is accepted that longer duration investments increase the security risk within the portfolio; however this is inevitable in order to achieve the optimal return and still comply with the SLY principle which is a cornerstone of treasury management within local authorities.

6.2. Section 1 of Appendix B (the annual *Treasury Management Investment Strategy*) provides more detail on how the risk is mitigated.

6.3. The Council does not have a specific risk register for Treasury Management but it does feature within the Finance risk register.

6.4. By engaging with our treasury management consultants, Link Group ('Link'), the Council is able to minimise the risks to which it is exposed. Link provide regular briefings, alerts and advice in respect of the Council's portfolio. They also provide training for Members and officers responsible for the Council's treasury management function, to ensure they are informed and competent.

6.5. **Brexit.** While the UK has been gripped by the long running saga of whether or not a deal would be made by 31 December 2020, the final agreement on 24 December 2020, followed by ratification by Parliament and all 27 EU countries in the following week, has eliminated a significant downside risk for the UK economy. The initial agreement only covers 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. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.The treasury management function will continue to keep this and other issues under review, and bring forward modified strategies for approval should the need arise.

## 7. Alternative Option(s) considered

7.1. An alternative to the strategy being proposed for 2021/22 would be to not alter the current strategy to invest without specific reference to any Environmental, Social and Governance (ESG) issues.

## 8. Background

8.1. The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return (i.e. Security, Liquidity, Yield = "SLY").

8.2. The second main function of the treasury management service is the funding of the capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially longer-term cash-flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

8.3. The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested (i.e the "S" in "SLY" above), as a loss of principal would result in a chargeable loss to the General Fund.

8.4. Whilst any 'commercial' (but not primarily 'for yield') initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure), and are separate from the day to day treasury management activities.

8.5. CIPFA defines treasury management as:

> *"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

8.6. No new reporting is required for the 2021/22 reporting cycle due to any revisions of the MHCLG *Investment Guidance*, the MHCLG *Minimum Revenue Provision (MRP) Guidance,* the CIPFA *Prudential Code* or the CIPFA *Treasury Management Code*.

## 9. Reporting requirements

### 9.1. Capital Strategy

9.1.1. The CIPFA 2017 Prudential and Treasury Management Codes requires local authorities to prepare a **Capital Strategy** report, which provides the following:

- a high-level long-term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability.

9.1.2. The aim of the Capital Strategy is to ensure that all elected members on full Council understand the overall long-term policy objectives and the resulting capital strategy requirements, governance procedures and risk appetite.

9.1.3. This capital strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under Security, Liquidity and Yield (SLY) principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy shows:

- The corporate governance arrangements for these types of activities;
- Any service objectives relating to the investments;
- The expected income, costs and resulting contribution;
- The debt related to the activity and the associated interest costs;
- The payback period (MRP policy);
- For non-loan type investments, the cost against the current market value;
- The risks associated with each activity.

9.1.4. Where a physical asset is being bought, details of market research, advisers used, (and their monitoring), ongoing costs and investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash.

9.1.5. Non-treasury investments that are for Investment Regeneration purposes would, eventually, be subject to a *Investment Regeneration Strategy*. Until such a strategy has been produced the Council will evaluate each opportunity on an ad hoc basis.

9.1.6. Where the Council has borrowed to fund any non-treasury investment, there should also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

9.1.7. If any non-treasury investment sustains a loss during the final accounts and audit process, the strategy and revenue implications will be reported through the same procedure as the capital strategy, i.e. through the budget monitoring process and reports to members.

9.1.8. To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this report, where appropriate.

9.1.9. The Capital Strategy has not been reviewed during 2020/21, other than new approvals, and will be updated during 2021/22 to reflect significant new policies and strategies, including the Climate Emergency Declaration and the *Asset Management Strategy*.

## 9.2. Treasury Management reporting

9.2.1. The Council is currently required to receive and approve, as a minimum, three main treasury reports each year, which incorporate a variety of policies, estimates and actuals:

a. **Prudential and treasury indicators and treasury strategy** (within this report at Appendix D) - The first, and most important, report is forward looking and covers:
   - the capital plans (including prudential indicators);
   - a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
   - the treasury management strategy (how the investments and borrowings are to be organised), including treasury indicators; and
   - an investment strategy (the parameters on how investments are to be managed).

b. **A mid-year treasury management report** – This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision.

c. **An annual treasury report** – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

9.2.2. The above reports are required to be adequately scrutinised before being recommended to the Council. This role is currently undertaken by the Finance and Audit Scrutiny Committee.

# Appendices

A Treasury Management Strategy

B Annual Investment Strategy

Annex 1 - Types of Investment
Annex 2 - Counterparty Limits
Annex 3 - Approved Countries for Investment

C Minimum Revenue Provision Policy

D Prudential Indicators

E Link Economic Background

F Interest Rate Forecasts

**Appendix A**

# Treasury Management Strategy for 2021/22

The strategy for 2021/22 covers two main areas:

## A. Capital issues

- the minimum revenue provision (MRP) policy – see Appendix C.
- the capital expenditure plans and the associated prudential indicators – Capital Expenditure Plans form part of the General Fund Budget report and the prudential indicators are included in Appendix D.

## B. Treasury management issues

- the current treasury position
- treasury indicators which limit the treasury risk and activities of the Council (Appendix D)
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy (Appendix B)
- creditworthiness policy (Appendix B, section 3)
- training
- benchmarking
- performance and
- the policy on the use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, MHCLG MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

## 1 Training

1.1 The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Following the May 2019 Council elections, Link Asset Services (Link) delivered training to Members of the Finance and Audit Scrutiny Committee and other interested Members in November 2019. Further training will be provided as and when required.

1.2 Officers involved in treasury management have received training from the Council's treasury consultants, CIPFA and other providers, as well as from a previous post holder. This knowledge will be kept up to date by regular attendance at seminars held by our consultants and other sources, such as CIPFA publications and market intelligence.

## 2 External service providers

2.1 The Council uses Link Group, Treasury Solutions ('Link') as its external treasury management advisor. The option to extend the contract with Link by two years was exercised, taking the current agreement to January 2022.

2.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed on the services of external service providers. All decisions will be undertaken with regards to all available information, including but not solely our treasury advisers.

2.3 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2.4 Banking services are provided by HSBC Bank Plc, with the current agreement running until February 2025.

**3 Benchmarking**

3.1 Link co-ordinates a sub-regional treasury management benchmarking service of which Warwick District Council is an active participant. The Council aims to achieve or exceed the weighted average rate of return of the Link model portfolio, which is published quarterly.

**4 Performance**

4.1 Performance of the treasury function is reported twice yearly to the Finance and Audit Scrutiny Committee.

4.2 The Treasury Management Team will seek to achieve a return on its money market investments of 0.0625% over the London Interbank Bid Rate (LIBID) of a similar duration (LIBID refers to the average interest rate which major London banks are willing to borrow from each other).

**5 Prospects for interest Rates**

5.1 Link assists the Council to formulate a view on interest rates. Further information is contained in Appendix F.

5.2 The following table gives Link's central view as at 18 December 2020, before the new strain of COVID-19 was formally identified, on finance markets worldwide:

5.3 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 subsequent meetings to 5 November 2020, 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 in the forecast table above as economic recovery is expected to be only gradual and, therefore, prolonged.

5.4 **Bond 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 a heightened expectation 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.

5.5 While inflation targeting by the major central banks has been successful over the last thirty 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 had 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.

5.6 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 spiked up during the financial crisis in March, these yields fell sharply to unprecedented lows as investors panicked during March in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. Government bonds. However, major western central banks took rapid action to deal with excessive stress in financial markets during March 2020, 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. Gilt yields and PWLB rates have been at remarkably low rates so far during 2020/21.

5.7 As the interest forecast table for PWLB certainty rates above shows, there is expected 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 COVID-19 shutdown period. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment, (as shown on 9 November 2020 when the first results of a successful vaccine trial were announced). Such volatility could occur at any time during the forecast period.

## 6 Investment and borrowing rates

6.1 **Investment returns** are likely to remain exceptionally low during 2021/22 with little increase expected in the following two years.

6.2 **Borrowing interest rates** fell to historically very low rates as a result of the COVID-19 crisis and the quantitative easing operations of the Bank of England: indeed, gilt yields up to 6 years were negative during most of the first half of 2020/21. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. The unexpected increase of 100 bps in PWLB rates on top of the then current margin over gilt yields of 80 bps in October 2019, required an initial major rethink of local authority treasury management strategy and risk management. However, in March 2020, the Government started a consultation process for reviewing the margins over gilt rates for PWLB borrowing for different types of local authority capital expenditure. It also introduced the differential rates for borrowing for different types of capital expenditure, with higher rates for non-housing schemes.

6.3 As a consequence of these increases in margins, many local authorities decided to refrain from PWLB borrowing unless it was for HRA or local infrastructure financing, until such time as the review of margins was concluded.

6.4 On 25 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)[1]

6.5 **Borrowing for capital expenditure**. As Link's long-term forecast for Bank Rate is 2.00%, and all PWLB rates are under 2.00%, there is now value in borrowing from the PWLB for all types of capital expenditure for all maturity periods, especially as current rates are at historic lows. However, greater value can be obtained in borrowing for shorter maturity periods so the Council will assess its risk appetite in conjunction with budgetary pressures to reduce total interest costs. Longer-term borrowing could also be undertaken for the purpose of certainty, where that is desirable, or for flattening the profile of a heavily unbalanced maturity profile.

6.6 While this authority will not be able to avoid borrowing to finance new capital expenditure and the rundown of reserves, there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

## 7 Borrowing Strategy

7.1 The capital expenditure plans set out in Section 4 of Appendix D provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

7.2 The Council's current long-term borrowing portfolio consists of £136.157 million HRA and £12 million General Fund PWLB debt. The Council has no short-term borrowing other than finance leases.

7.3 These HRA loans were taken out in 2012 to finance the HRA Self Financing settlement, and the interest paid on this debt is entirely borne by the HRA and is provided for as part of the HRA Business Plan. The first of these loans is scheduled to be repaid on 28 March 2053 with the final loan being repaid on

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[1] 3rd Round ran from 11th April to 11th July 2020 so closed until HM Treasury announces a 4th Round

28 March 2062. As part of reviwing the HRA Business Plan in December 2020, the Executive agreed that the Business Plan should allow for this debt to be replaced, so maintaining the overall level of debt and so give additional funds to invest in the housing stock.

7.4 £12 million was borrowed in September 2019, for repayment at maturity on 28 August 2059, with the interest borne by the General Fund, largely covering unfinanced capital expenditure in 2017/18 and 2018/19 (primarily relating to the Leamington and Warwick Leisure Centres).

7.5 The Council has been maintaining an under-borrowed position, which means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure, i.e. borrowing has been deferred. This strategy has been prudent while investment returns are historically low and counterparty risk is more unpredictable than usual.

7.6 The borrowing undertaken in 2019 has reduced the under-borrowed position of the previous two financial years. The position is not sustainable in the longer-term as (i) the Council will eventually need to replenish the cash backing the Reserves and Balances in order to pay for future developments, and (ii) the upside risk of PWLB and other borrowing rates as a result of economic factors make it prudent to consider "externalising" more of the internal borrowing by taking PWLB loans during 2021/22.

7.7 Additionally, there are a number of potential very large housing-related and other capital schemes that would significantly deplete or extinguish investment balances unless considerable external borrowing in 2020/21 or 2021/22 and beyond is undertaken. Please see Appendix D, Tables 4 and 5, for details of proposed capital expenditure and financing, including the borrowing requirement. Approval of these within the borrowing limits does not commit the Council to progressing with these schemes.

7.8 Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 treasury operations. The Head of Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

7.9 If it was forecast that there was a significant risk of:

- a sharp FALL in borrowing rates, then borrowing will be postponed for as long as practical;
- a much sharper RISE in borrowing rates than that currently forecast, perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised.

Most likely, fixed rate funding will be drawn whilst interest rates are in line with current projections for the next few years.

7.10 **Approved sources of long and short-term borrowing**

| On Balance Sheet | Fixed | Variable |
|---|---|---|
| Public Works Loan Board (PWLB) | ✓ | ✓ |
| Municipal Bond Agency (MBA) | ✓ | ✓ |
| Local authorities | ✓ | ✓ |
| Banks | ✓ | ✓ |
| Pension funds | ✓ | ✓ |
| Insurance companies | ✓ | ✓ |
| | | |
| Market (long-term) | ✓ | ✓ |
| Market (temporary) | ✓ | ✓ |
| Market (LOBOs) | ✓ | ✓ |
| Stock issues | ✓ | ✓ |
| | | |
| Local temporary | ✓ | ✓ |
| Local bonds | ✓ | X |
| Local authority bills | ✓ | ✓ |
| Overdraft | X | ✓ |
| Negotiable bonds | ✓ | ✓ |
| | | |
| Internal (capital receipts & revenue balances) | ✓ | ✓ |
| Commercial paper | ✓ | X |
| Medium term notes | ✓ | X |
| Finance leases | ✓ | ✓ |

7.11 The degree which any of these options proves cheaper than PWLB Certainty Rate is still evolving at the time of writing - and was significantly effected by the reduction in non-housing PWLB rates in late November 2020 - but the Council's advisors will keep officers informed. Financial institutions and the Municipal Bond Agency (MBA) are likely to have significantly more complex administration and legal arrangements than PWLB loans, even though those arrangements became more demanding in November.

7.12 The Council will use short-term borrowing (up to 365 days), if necessary, in order to finance temporary cash deficits. However, proactive cash flow management will aim to keep these to a minimum and, wherever possible, the loan would be taken out for periods of less than 7 days in order to minimise the interest payable. The Council has not incurred any short-term borrowing (other than minimal bank overdrafts) in 2020/21 to date and is not expecting to during 2021/22.

7.13 Any decisions will be reported to the appropriate decision making body at the next available opportunity.

## 8 Policy on borrowing in advance of need

8.1 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

8.2 Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

## 9 Current treasury position

9.1 The investments at 21 December 2020 are summarised below:

| Type of Investment | 21 Dec 20 £'000 | 30 Sep 20 £'000 | 31 Mar 20 £'000 |
|---|---|---|---|
| Money Markets incl. CD's & Bonds | 37,000 | 38,500 | 42,500 |
| Money Market Funds | 41,552 | 35,561 | 18,125 |
| Business Reserve Account | 3 | 3 | 5,000 |
| **Total In House Investments** | **78,555** | **74,064** | **65,625** |
| Corporate Equity Funds (nominal value) | 6,000 | 6,000 | 6,000 |
| **Total Investments** | **84,555** | **80,064** | **71,625** |

9.2 The market valuations of the two equity funds, as opposed to the nominal value included above, are shown below:

| Equity Fund | 21 Dec 20 £'000 | 30 Sep 20 £'000 | 31 Mar 20 £'000 |
|---|---|---|---|
| Royal London UK Equity Fund | 3,121 | 2,705 | 2,553 |
| Columbia Threadneedle UK Equity Income Fund | 3,102 | 2,803 | 2,569 |
| **Total** | **6,223** | **5,508** | **5,122** |

9.3 These equity fund valuations at 21 December 2020 include unrealised capital gains and dividends, the latter being amounts that have been credited to the General Fund since inception and are retained within the above values. At the time of writing the funds would need to increase in value by around £600,000 to accommodate the dividends and the unrealised losses.

9.4 The amount of ‘extraction of fossil fuel’ related investments within the two funds at the end of October 2020 was (a) Royal London – 5.55% and (b) Columbia Threadneedle – 4.86%. The Council does not have any influence over where these pooled equity funds invest.

9.5 Alternative ESG (Environmental, Social and Governance) equity funds are available, which operate with either negative (‘avoiding’) screening or positive screening. The appropriateness of these ESG funds would be considered in conjunction with the consideration of the planned increase in borrowing need.

9.6 The corresponding borrowing position is summarised below:

| External Borowing | 21 Dec 20 £'000 | 30 Sep 20 £'000 | 31 Mar 20 £'000 |
|---|---|---|---|
| Public Works Loan Board | 148,157 | 148,157 | 148,157 |
| **Total** | **148,157** | **148,157** | **148,157** |

## 10 Debt rescheduling

10.1 Rescheduling of borrowing in the Council's debt portfolio will remain uneconomic within current interest rates, given the high premia the PWLB would charge.

10.2 The Council's treasury advisors will continue to monitor the debt portfolio and identify any opportunities for debt restructuring but there would need to be a significant increase in interest rates for this occur.

10.3 If rescheduling was done, it would be reported to the Finance and Audit Scrutiny Committee, or equivalent, at the earliest meeting following its action.

# Annual Treasury Management Investment Strategy

## 1 Investment policy – management of risk

1.1 The MHCLG[2] and CIPFA[3] have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy, (a separate report).

1.2 The Council's investment policy has regard to the following:

- MHCLG's Guidance on Local Government Investments ("the Guidance"),
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code"),
- CIPFA Treasury Management Guidance Notes 2018.

1.3 The Council's investment priorities, using the established 'SLY' principles in decreasing importance, are:

1. **S**ecurity,
2. **L**iquidity and
3. **Y**ield return.

1.4 The above guidance from the MHCLG and CIPFA place a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

1.4.1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

1.4.2. **Other information**: ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as '**credit default swaps**' and overlay that information on top of the credit ratings.

1.4.3. **Other information sources** used will include the financial press, share price and other such information pertaining to the financial sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

1.4.4. This authority has defined the list of **types of investment instruments** that the treasury management team are authorised to use under the categories of 'specified' and 'non-specified' investments:

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[2] Ministry of Housing, Communities & Local Government
[3] Chartered Institute of Public Finance & Accountancy

- **Specified investments** are those with a high level of credit quality and subject to a maturity limit of one year.
- **Non-specified investments** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use. Once an investment is classed as non-specified, it remains non-specified all the way through to maturity i.e. an 18-month deposit would still be non-specified even if it has only 11 months left until maturity.
- **Commercial investments** are outside the Council's treasury management strategy and may eventually be subject to the development of a new *Investment Regeneration Strategy*. The Public Works Loan Board has introduced new rules in December 2020 allowing local government borrowing which can only be accessed if you have no Investment Assets bought primarily for yield.

1.4.5. **Non-specified investments limit**. The Council has determined that it will limit the maximum total exposure to non-specified investments as being 70% of the total investment portfolio.

1.4.6. **'Commercial' investments limit**. The Council would determine the maximum exposure to 'commercial' investments (including loans to third parties at commercial rates of interest but excluding "Investment Assets bought primarily for yield"), expressed as a percentage of the total investment portfolio, as part of the prospective development and approval of a *Investment Regeneration Strategy*.

1.4.7. **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in Appendix B Annex 2.

1.4.8. **Transaction limits** are not set for each type of investment, being subject to the overall lending limit in 1.4.7 above.

1.4.9. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**. (70% - see paragraph 3.11 below).

1.4.10. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (Appendix B Annex 2).

1.4.11. This authority has engaged **external consultants**, (Appendix A section 2), to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

1.4.12. All investments will be denominated in **sterling**.

1.4.13. As a result of the change in **accounting standards** for 2020/21 under IFRS 9, this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund[4]. This override applies to the Council's equity funds

[4] In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to

and will be a factor in their appropriateness after 2022/23.

1.5 However, this authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

**2. Changes in risk management policy from last year**

2.1 The above criteria are unchanged from last year.

**3. Creditworthiness policy**

3.1 The Council applies the creditworthiness service provided by the Link Group. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies: Fitch, Moody's and Standard & Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- 'watches' and 'outlooks' from credit rating agencies
- Credit Default Swap (CDS) spreads that may give early warning of changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries.

3.2 All credit ratings will be monitored routinely and will inform every investment decision. The Council is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service:

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap spreads against the iTraxx European Financials benchmark and other market data on a daily basis via its *Passport* website, provided exclusively to it by Link. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

3.3 Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, as well as information on any external support for banks to help support its decision making process.

3.4 All investments in property, corporate bond and corporate equity funds will be supported by the advice of Link, the Council's treasury advisors.

3.5 The Council will ensure that it maintains the lists of permitted investments and counterparty limits (Annexes 1 and 2) and will revise and submit the criteria to Council for approval when required. In respect of counterparty limits, the Council's investment balances have increased in recent years mainly due to increasing Housing Revenue Account (HRA) balances that are projected to be

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adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1 April 2018 utilised in the medium term.

3.6 In order to provide flexibility and to continue to be able to invest in the highest quality counterparties it is proposed to keep the counterparty limits for certain institutions as follows:

| Institution Type | Limit |
|---|---|
| A rated private banks | £5m |
| A+ rated private banks | £7m |
| AA rated private banks | £8m |
| Government Debt CNAV MMFs[5] | £10m |
| LVNAV MMFs[6] | £10m |

3.7 The Council has both cash flow derived and core balances available for investment. Investment decisions will be made with regard to cash flow requirements, core cash balances and the outlook for short term interest rates.

3.8 The Council will continue to use Money Market Funds (MMFs), call bank accounts and the money markets to invest cash flow driven money until the time when it is required. Core investments will be invested in a combination of corporate equity funds and the financial markets.

3.9 The Council has two corporate equity fund managers, Royal London Asset Management and Columbia Threadneedle, the performance of which are kept under review. Currently the funds are expected to make dividend returns of around 2.7% in 2021/22, although this is subject to many caveats including post-Brexit and the COVID-19 pandemic. These specific equity funds do invest in companies extracting fossil fuels[7] and the recommendation is to divest from these funds by the end of 2025 as part of the Council’s Climate Emergency Declaration. Options include closing these funds (reflecting the underlying use of balances and reserves) or re-investing in ESG (Environmental Social & Governance) equity funds. Any new fund manager appointments would be made in conjunction with the treasury advisers and in adherence with the Council’s procurement rules. Re-procuring to invest these funds is likely to incur an additional cost, as well as taking officer and member time. The issue of the increase in fund values necessary to remove unrealised losses in included in Appendix A at paragraph 9.3.

3.10 Based on its cash flow forecasts (subject to any ‘internal borrowing’ pending borrowing for new capital expenditure, including commercial investment), the Council anticipates that its investments in 2021/22 on average will be in the region of £75m, of which £32m will be “core” investments i.e. made up of reserves and balances which are not required in the short term.

3.11 The maximum percentage of its investments that the Council will hold in long-term investments (over 365 days) is 70%. It follows therefore that the

[5] Constant Net Asset Value Money Market Funds
[6] Low-Volatility Net Asset Value Money Market Funds
[7] Oil and gas, less that 5% of the combined portfolio at the end of October 2020

minimum percentage of its overall investments that the Council will hold in short term investments (365 days or less) is 30%. Having regard to the Council's likely cash flows and levels of funds available for investment the amount available for long-term investment will be a maximum of 70% of the core investment portfolio subject to a total of £30 million at any one time in line with the Prudential Indicator covering this issue. These limits will apply jointly to the in house team and any fund managers so that the overall ceilings of 70% and £30 million are not breached.

3.12 The 2021/22 interest rate outlook is for Bank Rate to start the year at 0.10% and Link expect it to remain at that level until the end of 2023/24. Based on current investment policies and interest rate projections, it is currently estimated that the overall portfolio will achieve a 0.50% return for 2021/22, augmented by the dividends from the equity funds.

## 4. Investments that are not part of treasury management activity

4.1 Where, in addition to treasury management investment activity, the Council invests in other financial assets and property where financial return is a significant but not the primary driver (to avoid the Council being excluded from taking PWLB borrowing), these investments will be proportional to the level of resources available and the Council will ensure the same robust procedures for the consideration of risk and return are applied to these decisions.

4.2 The Council recognises that investment in other financial assets e.g. loans to third parties and property may be taken for non-treasury management purposes, thus requiring careful investment management. Such activity includes loans supporting service outcomes and commercial investments.

4.3 The Council's framework to consider such non treasury management investments would be reflected within the *Capital Strategy* and the potential new *Investment Regeneration Strategy*, referred to in this report. All such investment proposals will be considered on their own merits, and have regard to treasury management principles.

4.4 The Council will ensure the organisation's investments are covered in the capital programme, investment strategy or equivalent, and will set out, where relevant, the organisation's risk appetite and specific policies and arrangements for non-treasury investments. It will be recognised that the risk appetite for these activities may differ from that for treasury management.

**Appendix B Annex 1**

# Schedule of specified and non-specified investments

## Specified Instruments (365 days or less)

- Deposits with banks and building societies
- Deposits with UK Government, Nationalised Industries, Public Corporations, and UK Local Authorities
- UK Government Gilts
- Debt Management Agency Deposit Facility (DMADF)
- Government Debt Constant Net Asset Value Money Market Funds (AAA rated)
- Low Volatility Net Asset Value Money Market Funds (AAA rated)
- Variable Net Asset Value Money Market Funds (AAA rated)
- Certificates of deposits issued by banks and building societies
- Corporate Bonds issued by private sector financial institutions
- Corporate Bonds issued by financial institutions partly or wholly owned by the UK Government
- Corporate Bonds issued by corporates
- Covered Bonds issued by private sector financial institutions
- Covered Bonds issued by financial institutions partly or wholly owned by the UK Government
- Covered Bonds issued by corporates
- Supranational Bonds issued by Supranational Institutions or Multi-Lateral Development Banks
- Floating Rate Notes issued by private sector financial institutions
- Floating Rate Notes issued by financial institutions partly or wholly owned by the UK Government
- Floating Rate Notes issued by corporates
- Eligible Bank Bills
- Sterling Securities guaranteed by HM Government
- Repos

## Non Specified Investments

- Deposits with unrated building societies
- Deposits with banks and building societies greater than 365 days
- Deposits with UK Local Authorities greater than 365 days
- Certificates of deposits issued by banks and building societies greater than 365 days
- Corporate Bonds issued by private sector financial institutions greater than 365 days
- Corporate Bonds issued by financial institutions partly or wholly owned by the UK Government greater than 365 days
- Corporate Bonds issued by corporates greater than 365 days

- Covered Bonds issued by private sector financial institutions greater than 365 days
- Covered Bonds issued by financial institutions partly or wholly owned by the UK Government greater than 365 days
- Covered Bonds issued by corporates greater than 365 days
- Corporate Bond Funds
- Regulated Property Funds including Real Estate Investment Trusts
- CCLA Property Fund or other similar property fund
- Diversified asset funds (e.g. CCLA DIF)
- UK Government Gilts with over 365 days to maturity
- Supranational Bonds issued by Supranational Institutions or Multi-Lateral Development with over 365 days to maturity
- Corporate Equity Funds

**Appendix B Annex 2**

## Counterparty Limits

| Investment / counterparty type: | S/term | L/term | Viability / support | # Sovereign country min. credit rating | Max limit per counterparty | Max. maturity period | Use | Notes ref |
|---|---|---|---|---|---|---|---|---|
| **Specified instruments:** *(repayable within 12 months)* | **(FITCH or equivalent)** | | | | | | | |
| DMADF | n/a | | | AA- | £12m | 365 days | In house & EFM* | |
| UK Govt. / local authorities / public corporations / nationalised industries | n/a | | High | | £10m | 365 days | In house & EFM* | 11 |
| Bank - part nationalised UK | F1 | A | | AA- | £9m | 365 days | In house & EFM* | 1 & 2 |
| Bank - private (includes fixed term deposits, CDs and category 1 FRNs & bonds) | F1 | A | | AA- | £5m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | A+ | | AA- | £7m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | AA- & above | | AA- | £8m | 365 days | In house & EFM* | 1 & 2 |
| Other private sector financial institutions (includes category 1 FRNs & bonds) | F1 | A | | AA- | £4m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | A+ | | AA- | £6m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | AA- & above | | AA- | £7m | 365 days | In house & EFM* | 1 & 2 |
| Corporates (category 3 FRNs & bonds) | F1 | A | | AA- | £4m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | A+ | | AA- | £5m | 365 days | In house & EFM* | 1 & 2 |
| | F1 | AA- & above | | AA- | £6m | 365 days | In house & EFM* | 1 & 2 |
| Bank subsidairies of UK banks | Unrated | | | Explicit Parent Guarantee | £5m | 3 months | In house & EFM* | 1 & 3 |
| Money Market Fund (CNAV) | AAAm / Aaa-mf/AAAmmf | | | | £10m | liquid | In house & EFM* | |
| Money Market Fund (LVNAV) | AAAm / Aaa-mf/AAAmmf | | | | £10m | liquid | In house & EFM* | |
| Money Market Fund (VNAV) | AAAf S1 / Aaa-bf/ AAA/V1 | | | | £6m | liquid | In house & EFM* | 4 |
| Building societies - category A | F1 | A | | AA- | £4m | 365 days | In house & EFM* | 1a. |
| Building societies - category B | F1 | | | AA- | £2m | 365 days | In house & EFM* | 1a. |
| Corporate bonds - category 2 | | A | | | £9m | 365 days | In house & EFM* | 5 |
| Covered bonds - category 2 | | A | | | £9m | 365 days | In house & EFM* | 12 |
| Bonds - supranational / multi-lateral development banks | AAA / Govt Guarantee | | | | £5m | 365 days | In house & EFM* | |
| Floating Rate Notes (FRN) - category 2 | | A | | | £9m | 365 days | In house & EFM* | 6 |
| Eligible bank bills | n/a | | | Determined by EFM | £5m | 365 days | EFM* | |
| Sterling securities guaranteed by HM Government | n/a | | | AA- | 9m | not defined | EFM* | |

| Investment / counterparty type: | S/term | L/term | Viability / support | # Sovereign country min. credit rating | Max limit per counterparty | Max. maturity period | Use | Notes ref |
|---|---|---|---|---|---|---|---|---|
| **Non-specified instruments:** | **(FITCH or equivalent)** | | | | | | | |
| Building societies - assets > £500m | unrated category C | | | | £1m | 3 months | In house | 1b & 9 |
| Bank - part nationalised UK > 1 year | F1 | A | | AA- | £9m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| Bank - private (includes fixed term deposits, CDs and category 1 FRNs & bonds) | F1 | A | | AA- | £5m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | A+ | | AA- | £7m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | AA- & above | | AA- | £8m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| Other private sector financial institutions (includes category 1 FRN's & Bonds) | F1 | A | | AA- | £4m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | A+ | | AA- | £6m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | AA- & above | | AA- | £7m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| Corporates (category 3 FRN'S, Bonds) | F1 | A | | AA- | £4m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | A+ | | AA- | £5m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| | F1 | AA- & above | | AA- | £6m | 2 years | In house + advice & EFM* | 1b, 2, & 10 |
| Building societies - > 1 year | F1 | A | | AA- | £1m | 2 years | In house + advice & EFM* | 1b & 10 |
| Local authorities > 1 year | n/a | | High | | £9m | 5 years | In house + advice | 10 |
| Corporate bonds - category 2 > 1 year | | A | | | £9m | 2 years | In house & EFM* | 5 & 10 |
| Covered bonds - category 2 > 1 year | | A | | | £9m | 2 years | In house & EFM* | 10 & 12 |
| Corporate Equity Funds - low risk | | N/A | | See note 13 | £4m | 10 years | EFM* | 13 & 14 |
| Corporate Equity Funds - medium risk | | N/A | | See note 13 | £2m | 10 years | EFM* | 13 & 14 |
| Corporate Bond Funds | | BBB | | | £5m | 10 years | In house + advice & EFM* | 10 |
| Pooled property fund eg: REITS | | | | Authorised FS&MA | £5m | 10 years | In house + advice | 10 |
| CCLA property funds | n/a | | | see note 8 | £5m | 10 years | In house + advice | 7 & 10 |
| Day to day balances | n/a | | | | n/a | n/a | In house | 8 |

| **Notes:** | |
|---|---|
| * | EFM = External Fund Manager |
| # | Minimum sovereign rating does not apply to UK domiciled counterparties |
| | All maximum maturity periods include any forward deal period |
| 1. | Includes business call reserve accounts, special tranches & any other form of investment with that institution e.g. certificate of deposits, corporate bonds and repos, except where the repo collateral is more highly credit rated than the counterparty in which case the counterparty limit is increased by £3m with a maximum in repos of £3m |
| 1a. | Includes business call reserve accounts, special tranches & any other form of investment with that institution e.g. certificate of deposits, corporate bonds and repos, except where the repo collateral is more highly credit rated than the counterparty in which case the counterparty limit is increased by £2m with a maximum in repos of £2m |
| 1b. | Includes business call reserve accounts, special tranches & any other form of investment with that institution e.g. certificate of deposits, corporate bonds and repos |
| 2. | Counterparty limit is also the group limit where investments are with different but related institutions |
| 3. | Unrated but with explicit guarantee by parent + parent meets minimum ratings of short-term F1, long-term A. Subject to group limit relating to parent bank e.g. £5m if private of £9m if part or wholly nationalised |
| 4. | Subject to overall group limit of £6m |
| 5. | Corporate bonds must be senior unsecured and above. Category types: |
| | Category 1: Issued by private sector financial institutions |
| | Category 2: Issued by financial institutions wholly owned or part owned by the UK Government |
| | Category 3: Issued by corporates |
| 6. | Floating rate notes - categories as per note 5 above |
| 7. | Security of trustee of fund (LAMIT) controlled by LGA, COSLA who appoint the members and officers of LAMIT |
| 8. | Minimum exposure to credit risk as overnight balances only |
| 9. | Group limit of £8m |
| 10. | £15m overall limit for corporate bond / equity / property funds & £20m limit for all counterparties |
| 11. | UK Government includes gilt edged securities and Treasury bills |
| 12. | Covered bonds category types: |
| | Category 1: Issued by private sector financial institutions |
| | Category 2: Issued by financial institutions wholly owned or part owned by the UK Government |
| | Category 3: Issued by corporates |
| 13. | Risk determined as follows: |
| | Low - UK equity income funds |
| | Medium - UK capital growth funds |
| 14. | Maximum investment limit subject to 10% capital growth, i.e. maximum is 110% of original investment |

**Appendix B Annex 3**

# Approved Countries for Investments

This list, as at 5 January 2021, is based on those countries which have sovereign ratings of AA- or higher, based on the lowest rating from Fitch, Moody's and S&P. Fallers since last year are in red itallic.

***Based on lowest available rating***

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- *Canada*
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- *Hong Kong*
- Qatar
- *U.K.*

**Appendix C**

# Minimum Revenue Provision Policy

## 1 Background

1.1 The Council is required to pay off an element of the accumulated General Fund capital spend each year (the Capital Financing Requirement - CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision - VRP).

1.2 MHCLG regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following **MRP Statement**.

1.3 The *Statutory Guidance on Minimum Revenue Provision*[8] offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.

## 2 Four Main Options

### 2.1 Option 1 – Regulatory Method

This option is the old statutory method of 4% of the CFR and which has to be used in order to calculate MRP on all debt still outstanding at 1 April 2008[9]. It can also be used to calculate MRP on debt incurred under the new system but which is supported through the annual SCE (Supported Capital Expenditure) allocation from DCLG.

### 2.2 Option 2 – Capital Financing Requirement Method

This is a variation of Option 1 and is based on 4% of the CFR with certain changes and is appropriate where the borrowing is not linked to a particular asset.

### 2.3 Option 3 – Asset Life Method

Under this option, it is intended that MRP should be spread over the useful life of the asset financed by the borrowing or credit arrangement. In future, where borrowing is utilised to finance specific assets it is likely that the period of the loan will match the expected life of the asset and therefore, under this method the annual charge to the Council's accounts is directly related to building up the provision required to pay off the loan when it matures which, under Options 1 and 2, is not possible.

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[8] Guidance issued by the Secretary of State under section 21(1A) of the *Local Government Act 2003*. Fourth edition applies to periods commencing 1 April 2019.
[9] The Council had no debt at this date

There are 2 methods of calculating the annual charge under this option

a) equal annual instalments or
b) by the annuity method where annual payments gradually increase during the life of the asset.

**2.4 Option 4 – Depreciation Method**

This is a variation on option 3 using the method of depreciation attached to the asset e.g. straight line where depreciation is charged in equal instalments over the estimated life and the reducing balance method where depreciation is greater in the early years of an assets life and which is most appropriate for short lived assets e.g. vehicles. In this Council's case assets are depreciated using the straight line method and so option 4 is not materially different from option 3.

**3 HRA**

3.1 There is no requirement on the HRA to make a MRP but there is a requirement for a charge for depreciation to be made.

3.2 Under the Self Financing regime, the HRA Business Plan has to provide resources for the repayment of the £136.157m borrowed from the PWLB on the 28 March 2012. Repayment of this debt is currently provided for commencing in year 41 (2052/53) and continuing through to year 50 year of the Business Plan.

3.3 The HRA will apply the same principle to new borrowing undertaken for capital investment.

**4 Voluntary Revenue Provision (VRP)**

4.1 MHCLG issued revised MRP guidance in 2018 concerning Voluntary Revenue Provision. In future any VRP or overpayment of MRP, which has been disclosed in previous years' MRP statement, can be reclaimed and credited back to the General Fund in certain circumstances. An example would be a loan to a third party where during the duration of the loan MRP or VRP has been made but on full repayment of the loan the principal has been applied to pay down the Capital Financing Requirement. In this instance the VRP is no longer required and can be released back to the General Fund. The Council has instances of such loans but has elected to not make MRP or VRP on these as they are of relatively short duration and on repayment the principal repaid will be applied to pay down the Capital Financing Requirement.

**5 Warwick District Council Policy**

5.1 It is recommended that for any long-term borrowing on the General Fund e.g. leisure centre refurbishments, the following methods of Minimum Revenue Provision be adopted:

- For borrowing specifically linked to a particular asset or capital scheme – Option 3 based on the annuity method.
- For borrowing that cannot be linked to a particular asset or capital scheme – Option 3 based on the annuity method using the weighted average life of assets.

5.2 For any borrowing incurred through finance leases, the annual principal repayments in the lease are regarded as MRP.

5.3 Although not strictly part of MRP requirements, it is also recommended that for internal borrowing (i.e. capital expenditure financed from reserves), where appropriate, Option 3 based on the annuity method be adopted, in most cases, as a means of replenishing those reserves which financed the capital expenditure. In exceptional circumstances another method may be more appropriate.

5.4 For short to medium duration loans to third parties the Council will not make either MRP or VRP but instead apply the capital receipt received through the repayment of the loan to pay down the Capital Financing Requirement.

5.5 The Council may on occasion enter into agreement to undertake a scheme / capital payment whereby monies and resources (grants, capital receipts, S106 receipts, etc.) will be received some time after the scheme / capital payment has been completed. On such occasions whereby the capital expenditure is expected to be fully reimbursed by future capital or revenue income, no MRP will be provided. This position will be kept under review and should the likelihood of receipt of the income change, then MRP may be initiated. Such an example would be the granting of monies to an external organisation and S106 receipts are expected to pay for the capital liability.

**Appendix D**

# Prudential and Treasury Indicators

## 1. Introduction

1.1. The Prudential Capital Finance system came into effect on 1 April 2004, replacing the previous system of approval allocations from central Government, allowing local authorities to decide how much they can prudently afford to borrow *and* pay back from revenue resources.

1.2. CIPFA developed the Prudential Code for Capital Finance in Local Authorities (the 'Prudential Code') to provide a mechanism to enable councils to ensure, that in line with the new freedom given, their capital investment plans are affordable, prudent and sustainable.

1.3. It is the Council's responsibility to set its prudential indicators, having regard to its own set of circumstances. The Council must demonstrate that its capital investment proposals are:

- affordable
- prudent and
- sustainable.

1.4. All Indicators must be included in the Council's annual Treasury Strategy and Outturn report.

1.5. The Prudential and Treasury Indicators are divided into:

a) Prudential:

- Affordability (section 2)
- Prudence (section 3)
- Capital Expenditure (sections 4 - 5)
- External Debt (sections 6 - 7)

b) Treasury:

- Treasury Indicators (section 8).

1.6. This Appendix explains what the Prudential and Treasury Indicators are as well as revising them for the current year, 2020/21, where appropriate and setting them for future years.

## 2. Affordability - Ratio of financing costs to net revenue stream

2.1. This ratio shows the trend in the cost of capital (borrowing and other long-term obligation costs, net of investment income) against the net revenue stream, i.e. taxation, rents and non-specific grant income.

2.2. The higher the ratio, the higher the proportion of resources tied up just to service met capital costs, and which represent a potential affordability risk.

2.3. It sets an upper limit on the proportion of the Council's net revenue streams both for General Fund and Housing Revenue Account (HRA) that is committed to servicing debt.

2.4. The table below shows the actual for 2019/20 and the ratios proposed for the General Fund, HRA and Overall as required by the Prudential Code. These figures exclude unapproved schemes, other than schemes subject to approval at the same Council meeting as this report.

*Table 1*

| Year | General Fund | Housing Revenue Account | Overall |
|---|---|---|---|
| 2019/20 | -1.9% | 38.4% | 21.3% |
| 2020/21 | -2.00% to 4.00% | 38.00% to 50.00% | 23.00% to 33.00% |
| 2021/22 | 0.00% to 7.00% | 38.00% to 50.00% | 24.00% to 35.00% |
| 2022/23 | 0.00% to 8.50% | 38.00% to 50.00% | 24.00% to 35.00% |
| 2023/24 | 0.00% to 10.00% | 38.00% to 50.00% | 24.00% to 35.00% |

2.5. The ratio for estimates is a range rather than a single figure (except the 2019/20 actual), to allow for both the uncertain amount of borrowing that will take place for developments by the General Fund and HRA (such as the Housing Company), and the possible movements in long-term interest rates, as a relatively small variation from today's low level in borrowing costs could cause a ratio based on a precise percentage to be breached.

2.6. The significant size of the HRA ratio includes the HRA self-financing debt taken in 2012 and future potential borrowing for increasing the supply of dwellings, some through a Housing Company. If income increases at least much as the debt costs the ratio should not increase once the new rental properties are occupied – there will be a short-term cost during any acquisition and construction.

2.7. The General Fund ratio would increase for further borrowing to finance capital expenditure such as Housing Company loan, leisure centres and long-term loans to third parties.

2.8. The ratios will be monitored during the year and, if necessary, remedial action taken – such as Council increasing the limits - to avoid them being breached.

## 3. Prudence - Gross Debt and the Capital Financing Requirement

3.1 This indicator requires that gross debt, except in the short term, is to be kept below the Capital Financing Requirement (CFR) for the same period. This demonstrates that borrowing has not been taken in advance of need. It is estimated that gross external debt will be lower than the CFR in future years.

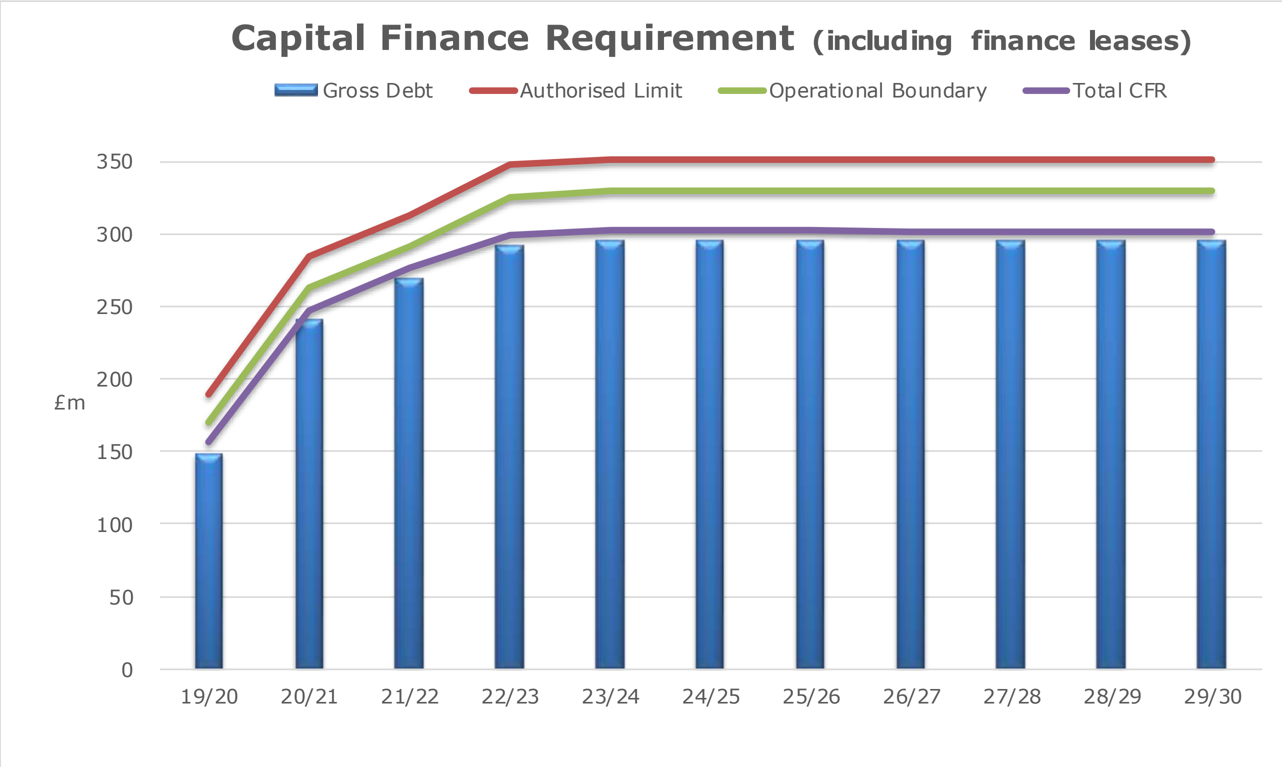
3.2 Table 2 shows the longer term projections, compared with total debt and the Authorised Limit and Operational Boundary from sections 6 and 7 respectively:

*Table 2*

| **Capital Financing Requirement** (including finance leases) | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **£m** | **Actual 19/20** | **Est 20/21** | **Est 21/22** | **Est 22/23** | **Est 23/24** | **Est 24/25** | **Est 25/26** | **Est 26/27** | **Est 27/28** | **Est 28/29** | **Est 29/30** |
| HRA CFR | 136.2 | 159.0 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 |
| GF CFR | 14.8 | 18.8 | 22.6 | 42.2 | 47.6 | 47.5 | 47.5 | 47.5 | 47.5 | 47.5 | 47.5 |
| 'Commercial' activity / non-financial investments | 5.5 | 70.0 | 73.1 | 76.1 | 74.5 | 74.4 | 74.2 | 74.0 | 74.0 | 74.0 | 74.0 |
| **Total CFR** | **156.4** | **247.8** | **276.3** | **298.9** | **302.6** | **302.4** | **302.2** | **302.1** | **302.1** | **302.1** | **302.1** |
| External borrowing - HRA | 136.2 | 159.0 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 | 180.5 |
| External borrowing - GF | 12.0 | 80.9 | 87.8 | 110.4 | 114.1 | 114.1 | 114.0 | 113.8 | 113.8 | 113.8 | 113.8 |
| Other long term liabilities | 0.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Gross Debt** | **148.2** | **240.8** | **269.3** | **291.9** | **295.7** | **295.7** | **295.5** | **295.4** | **295.4** | **295.4** | **295.4** |
| Internal borrowing - HRA | - | - | - | - | - | - | - | - | - | - | - |
| Internal borrowing - GF | 8.2 | 6.9 | 6.9 | 6.9 | 6.9 | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 | 6.7 |
| **WDC internal borrowing** | **8.2** | **6.9** | **6.9** | **6.9** | **6.9** | **6.7** | **6.7** | **6.7** | **6.7** | **6.7** | **6.7** |
| **Authorised Limit** | 189.3 | 284.9 | 313.4 | 347.9 | 351.7 | 351.7 | 351.7 | 351.7 | 351.7 | 351.7 | 351.7 |
| **Operational Boundary** | 170.3 | 262.9 | 291.4 | 325.9 | 329.7 | 329.7 | 329.7 | 329.7 | 329.7 | 329.7 | 329.7 |

3.3 These figures are shown in graphical form, demonstrating that the CFR will be higher than gross debt:

*Table 3*




3.4 The value of gross debt excludes unapproved borrowing for housing developments (General Fund for Housing Company and Joint Venture; HRA for the Housing Improvement Programme, including new build schemes), other than HRA schemes being considered in the same Council meeting. Approval of these limits does not commit the Council to the underlying schemes but the borrowing for these does rely on the Council approving the schemes and the limits in *Table 3*.

## 4. Capital Expenditure

4.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

4.2 The Council is required to publish its estimated capital expenditure for both the General Fund (GF) and Housing Revenue Account (HRA) for a minimum of the next three financial years, as well as the actual for the previous year and latest estimate for the current year.

4.3 By modelling various capital programme scenarios, including new HRA properties and commercial investment opportunities, this indicator provides the data for the ratio of financing costs to net revenue stream indicator.

4.4 Table 4 shows the Council's estimated capital expenditure on the General Fund and HRA for the next four years, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

*Table 4*

| Capital expenditure | 2019/20 Outturn £'000 | 2020/21 Estimate £'000 | 2021/22 Estimate £'000 | 2022/23 Estimate £'000 | 2023/24 Estimate £'000 |
|---|---|---|---|---|---|
| General Fund (non HIP) | 7,651 | 16,431 | 14,432 | 20,482 | 1,339 |
| Credit arrangements - finance leases | 30 | 12 | - | - | - |
| **Housing Investment Programme:** | | | | | |
| General Fund (HIP) | | 1,348 | - | - | - |
| HRA | 20,183 | 37,277 | 45,276 | 15,680 | 9,109 |
| 'Commercial' activities (including development) / non-financial investments* | 551 | 64,600 | 3,100 | 3,100 | 3,000 |
| **Total (A)** | **28,415** | **119,668** | **62,808** | **39,262** | **13,448** |

* - loans to third parties

## 5. Capital Financing Requirement

5.1 The Capital Financing Requirement (CFR) is a key measure that shows the underlying need for an authority to borrow for capital purposes, i.e. the difference between the Council's capital expenditure and the revenue or capital resources set aside to finance that spend. It is essentially a measure of the Council's indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for through a revenue or capital resource, will increase the CFR.

5.2 The borrowing may be either external (such as from the PWLB) or internal borrowing (where an authority temporarily utilises cash backing its reserves and balances rather than taking external loans). External borrowing creates a cost to the Council in terms of having to pay interest on and provide for repayment of external loans while internal borrowing creates lost investment interest and an exposure to future interest rate increases when loans must be taken. The CFR provides the starting point for calculating this cost and the results feed into the ratio of financing costs to net revenue stream indicator.

5.3 The CFR does not increase indefinitely, as the Minimum Revenue Provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each asset's life, and so charges the economic consumption of capital assets as they are used.

5.4 The CFR includes any other long-term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the lease provider and so the Council is not required to separately borrow for these schemes. The Council currently has £30,000 of such schemes within the CFR.

5.5 *Table 5* summarises how the capital expenditure plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need (i.e. an increase in the Capital Financing Requirement).

*Table 5*

| Financing of capital expenditure | 2019/20 Outturn £'000 | 2020/21 Estimate £'000 | 2021/22 Estimate £'000 | 2022/23 Estimate £'000 | 2023/24 Estimate £'000 |
|---|---|---|---|---|---|
| **HRA:** | | | | | |
| Capital receipts | 3,187 | 300 | 300 | 300 | 300 |
| Capital grants and contributions | - | 2,306 | 2,740 | - | - |
| Reserves | 16,874 | 11,754 | 20,520 | 15,257 | 8,686 |
| Revenue contributions | 122 | 123 | 123 | 123 | 123 |
| **Total HRA** | **20,183** | **14,483** | **23,683** | **15,680** | **9,109** |
| **General Fund:** | | | | | |
| Capital receipts | 454 | 1,595 | 160 | - | - |
| Capital grants and contributions | 5,491 | 9,152 | 5,513 | 349 | - |
| Reserves | 1,540 | 2,641 | 4,625 | 314 | 257 |
| Revenue contributions | 176 | 213 | 80 | 80 | 80 |
| **Total GF** | **7,661** | **13,601** | **10,378** | **743** | **337** |
| **Combined:** | | | | | |
| Capital receipts | 3,641 | 1,895 | 460 | 300 | 300 |
| Capital grants and contributions | 5,491 | 11,458 | 8,253 | 349 | - |
| Reserves | 18,414 | 14,395 | 25,145 | 15,571 | 8,943 |
| Revenue contributions | 298 | 336 | 203 | 203 | 203 |
| **Subtotal (B)** | **27,844** | **28,084** | **34,061** | **16,423** | **9,446** |
| **Net borrowing need for the year (A – B)** | **571** | **91,584** | **28,747** | **22,839** | **4,002** |

5.6 The net financing need for 'commercial' activities / non-financial investments included in *Table 5* against expenditure is shown in *Table 6*:

*Table 6*

| 'Commercial' activities / non-financial investments £'000 | 2019/20 Outturn | 2020/21 Estimate | 2021/22 Estimate | 2022/23 Estimate | 2023/24 Estimate |
|---|---|---|---|---|---|
| Capital expenditure | 551 | 64,600 | 3,100 | 3,100 | 3,000 |
| Financing costs (incl MRP) | 10 | 2,260 | 107 | 122 | 120 |
| **Net financing need for the year** | **561** | **66,860** | **3,207** | **3,222** | **3,120** |
| Percentage of total net financing need % | 96% | 71% | 11% | 14% | 75% |

5.7 These figures are illustrative at this point and are subject to the Council's approval of the underlying capital expenditure.

5.8 The CFR increases where unfinanced capital expenditure takes place and reduces as the Council makes a Minimum Revenue Provision (MRP).

5.9 This Council has four CFRs:

(a) the HRA

(b) the General Fund, which is further subdivided to show

(c) '*commercial* activities / non-financial investments' (which have, to date, been loans to third parties at commercial rates of interest), and

(d) combined total for the whole of the Council (the sum of a to c).

5.10 The estimated CFRs at the end of 2020/21 and each of the next three years are based on the Council's latest capital programme and exclude any unapproved 'commercial investment / non-financial activities' and additional HRA borrowing for schemes that are subject to viability appraisals, and which would be subject to future Council reports and revised Prudential Indicators, where appropriate. The General Fund CFR also includes the impact of the internal borrowing incurred to date, as well as the internal and external borrowing factored into the current 5-year General Fund Capital Programme.

5.11 The Council is asked to approve the CFR projections in *Tables 7* and *8*.

*Table 7*

| Capital Financing Requirement Year | (a) HRA £'000 | (b) General Fund £'000 | (c) 'Commercial' activities / non financial investments £'000 | (d) Total £'000 |
|---|---|---|---|---|
| 2019/20 | 136,157 | 14,782 | 5,475 | 156,414 |
| 2020/21 | 158,952 | 18,769 | 70,033 | 247,754 |
| 2021/22 | 180,546 | 22,613 | 73,098 | 276,257 |
| 2022/23 | 180,546 | 42,211 | 76,102 | 298,859 |
| 2023/24 | 180,546 | 47,556 | 74,516 | 302,618 |

*Table 8*

| £m | 2019/20 Outturn | 2020/21 Estimate | 2021/22 Estimate | 2022/23 Estimate | 2023/24 Estimate |
|---|---|---|---|---|---|
| **Capital Financing Requirement** | | | | | |
| CFR – non housing | 14.8 | 18.8 | 22.6 | 42.2 | 47.6 |
| CFR – housing | 136.2 | 159.0 | 180.5 | 180.5 | 180.5 |
| CFR - Commercial activities/ non-financial investments | 5.5 | 70.0 | 73.1 | 76.1 | 74.5 |
| **Total CFR** | **156.4** | **247.8** | **276.3** | **298.9** | **302.6** |
| Movement in CFR | 1.4 | 91.3 | 28.5 | 22.6 | 3.8 |
| | | | | | |
| **Movement in CFR represented by** | | | | | |
| Net financing need for the year ("A-B" above) | 0.6 | 91.6 | 28.7 | 22.8 | 4.0 |
| Less MRP/VRP and other financing movements | 0.8 | -0.3 | -0.2 | -0.2 | -0.2 |
| **Movement in CFR** | **1.4** | **91.3** | **28.5** | **22.6** | **3.8** |

5.12 A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the authority's overall financial position. The capital expenditure figures shown in *Table 4* and the details above demonstrate the scope of this activity (28% in 2020/21 and 26% in 2021) and, by approving these figures, Members consider the scale proportionate to the Authority's remaining activity.

5.13 The opening HRA CFR at 1 April 2020 was the HRA self-financing debt settlement of £136.157 million.

## 6. External Debt - Authorised Limit

6.1 The Council is required to set - for the forthcoming year and the following two financial years - an Authorised Limit for its total external debt, gross of investments, separately identifying borrowing from 'other long-term liabilities', the latter being credit arrangements, as defined in statute, and which include the principal element of finance leases (or Private Finance Initiative (PFI) if the Council had these contracts).

6.2 The Authorised Limit represents a control on the maximum level of external debt the Council can incur. The Council has no legal power to borrow in excess of the limits set.

6.3 The recommended Authorised Limit is as shown in *Table 9*:

*Table 9*

| Authorised Limit | 2019/20 Outturn £'000 | 2020/21 Latest £'000 | 2021/22 Estimate £'000 | 2022/23 Estimate £'000 | 2023/24 Estimate £'000 |
|---|---|---|---|---|---|
| Debt including HRA settlement | 189,279 | 192,234 | 192,234 | 204,115 | 204,115 |
| Other long-term liabilities | 30 | 1,012 | 1,000 | 1,000 | 1,000 |
| HRA HIP | - | 22,795 | 44,389 | 44,389 | 44,389 |
| General Fund HIP | - | 1,348 | 1,348 | 1,348 | 1,348 |
| Other General Fund capital programme | - | 3,030 | 6,939 | 26,541 | 27,300 |
| 'Commercial' activities / non-financial investments | - | 64,500 | 67,500 | 70,500 | 73,500 |
| **Total Authorised Limit** | **189,309** | **284,919** | **313,410** | **347,893** | **351,652** |

6.4 The Authorised Limit reflects a level of external debt that, although not preferred, could be afforded in the short-term but may not be sustainable in the longer-term. The Indicators for the Operational Boundary and Gross Debt & the CFR will both be set below the Authorised Limit.

6.5 The Authorised Limit takes account of the Housing Improvement Programme (HIP) and the General Fund capital programme. The figures for 'Commercial activities' are for amounts being considered by Council parallel to this report and would need to be excluded if not approved. It excludes additional HRA development and GF investment regeneration that would be expected to generate a net income stream – these are both subject to future Council decisions and could also require the Prudential Indicators to be formally amended.

6.6 The debt figure provides for the potential borrowing liability of vehicles under the combined waste collection / street cleansing / grounds maintenance contract that are due to commence on 1 July 2022, as the Council is able to borrow more cheaply than most contractors. The requirement for this borrowing, which would result in reduced payments to the contractor(s), should be known by mid-2021.

6.7 It should be noted that the figures for each year are cumulative.

## 7. External Debt - Operational Boundary

7.1 The Council is, additionally, required to set an Operational Boundary for external debt, which is for three years and gross of investments.

7.2 The Operational Boundary - which is less than the Authorised Limit - is effectively the day-to-day working limit for cash flow purposes, the level that external debt is not ordinarily expected to exceed. This indicator includes anticipated additional borrowing to cater for forecast capital activity.

7.3 An occasional breach of the Operational Boundary is not a cause for concern (provide that the Authorised Limit is not breached) but a sustained breach could indicate that there are problems with the Council's cash flow. Therefore, this indicator is monitored throughout the year and remedial action taken if necessary.

7.4 The recommended Operational Boundaries are as shown in Table 10. It should be noted that the figures for each year are cumulative (for instance, the £67.5m shown in 2021/22 for 'commercial' activities is the brought forward amount from 2020/21). They are based on the same assumptions outlined in paragraph 6.5 above.

*Table 10*

| **Operational Boundary** | **2019/20 Outturn £'000** | **2020/21 Latest £'000** | **2021/22 Estimate £'000** | **2022/23 Estimate £'000** | **2023/24 Estimate £'001** |
|---|---|---|---|---|---|
| Debt including HRA settlement | 170,279 | 168,886 | 168,886 | 180,767 | 180,767 |
| Other long-term liabilities | 30 | 1,012 | 1,000 | 1,000 | 1,000 |
| HRA HIP | - | 22,795 | 44,389 | 44,389 | 44,389 |
| General Fund HIP | - | 1,348 | 1,348 | 1,348 | 1,348 |
| Other General Fund capital programme | - | 4,378 | 8,287 | 27,889 | 28,648 |
| 'Commercial' activities / non-financial investments | - | 64,500 | 67,500 | 70,500 | 73,500 |
| **Total Operational Boundary** | **170,309** | **262,919** | **291,410** | **325,893** | **329,652** |

## 8. Treasury Indicators

8.1 The following indicators used to be part of the Prudential Code and are now part of the Treasury Management Code of Practice.

8.2 Maturity structure of borrowing:

a) Upper and Lower Limits respectively for the Maturity Structure of Fixed Interest Rate Borrowing:

*Table 11*

| **Period** | **Upper** | **Lower** |
|---|---|---|
| Under 12 months | 20% | 0% |
| 12 months & within 24 months | 20% | 0% |
| 24 months & within 5 years | 20% | 0% |
| 5 years & within 10 years | 20% | 0% |
| 10 years & above | 100% | 0% |

b) Upper and Lower Limits respectively for the Maturity Structure of Variable Interest Rate Borrowing:

*Table 12*

| Period | Upper | Lower |
|---|---|---|
| Under 12 months | 100% | 0% |
| 12 months & within 24 months | 100% | 0% |
| 24 months & within 5 years | 100% | 0% |
| 5 years & within 10 years | 100% | 0% |

c) Upper limits to fixed interest rate and variable interest rate exposures on borrowing:

*Table 13*

| Year | Upper Limit - Fixed Rate | Upper Limit - Variable Rate |
|---|---|---|
| 2021/22 | 100% | 30% |
| 2022/23 | 100% | 30% |
| 2023/24 | 100% | 30% |

8.3 Upper limit on total principal sums invested for periods longer than a year:

- The total maximum sum that can be invested for more than 365 days is 70% of the core investment portfolio, subject to a maximum of £30 million at any one time.

However, where investments which originally were for periods of more than 365 days currently have 365 days or less to maturity at the 1 April each year they shall be classed from that date as short term i.e. less than 365 day investments and will not count against the 70% or £30 million limit.

**Appendix E**

# Economic Background

**UK**

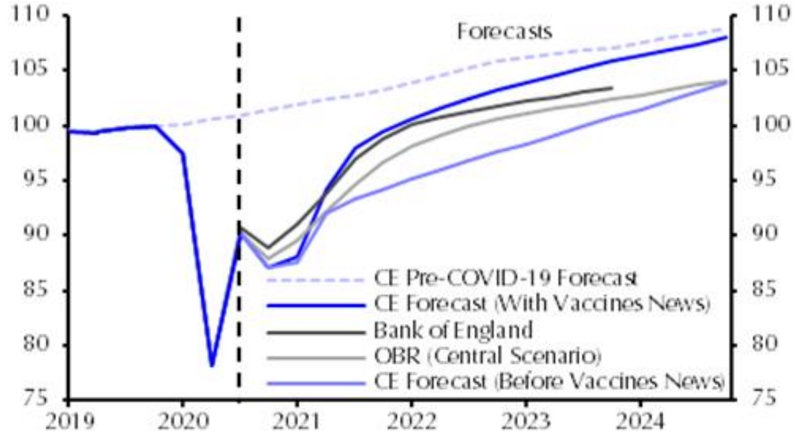
- The Bank of England's ("The Bank") Monetary Policy Committee (MPC) kept **Bank Rate** unchanged on 5 November 2020. However, it revised its economic forecasts to take account of a second national lockdown from 5 November to 2 December which will put back economic recovery and do further damage to the economy. The Bank, therefore, decided to do a further tranche of **quantitative easing** (QE) of £150bn, to start in January when the current programme of £300bn of QE announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at the time, to be rather optimistic in terms of three areas:
    - The economy would recover to reach its pre-pandemic level in Q1 2022
    - The Bank also expects there to be excess demand in the economy by Q4 2022.
    - CPI inflation is therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance** in August 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. Link's Bank Rate forecast currently shows no increase (or decrease) through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern.
- **Inflation** is expected to briefly peak at around 2% towards the end of 2021 but this is a temporary short lived factor and so not a concern.
- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. **Upside risks** included the early roll out of effective vaccines.
- **COVID-19 vaccines**. We had been waiting expectantly for news that various COVID-19 vaccines would be cleared as being safe and effective for administering to the general public. The Pfizer announcement on 9 November was very

encouraging as its 90% effectiveness was much higher than the 50-60% rate of effectiveness of flu vaccines which might otherwise have been expected. However, this vaccine has demanding cold storage requirements of minus 70c that impairs the speed of application to the general population. It has therefore been particularly welcome that the Oxford University / AstraZeneca vaccine has now also been approved which is much cheaper and only requires fridge temperatures for storage. The Government has 60m doses on order and is aiming to vaccinate at a rate of 2m people per week starting in January, though this rate is currently restricted by a bottleneck on vaccine production; (a new UK production facility is due to be completed in June).

- These announcements, plus expected further announcements that other vaccines could be approved soon, have enormously boosted confidence that **life could largely return to normal during the second half of 2021**, with activity in the still-depressed sectors like restaurants, travel and hotels returning to their pre-pandemic levels, which would help to bring the unemployment rate down. With the household saving rate currently being exceptionally high, there is plenty of pent-up demand and purchasing power stored up for these services. A comprehensive roll-out of vaccines might take into late 2021 to fully complete; but if these vaccines prove to be highly effective, then there is a possibility that restrictions could begin to be eased, possibly in Q2 2021, once vulnerable people and front-line workers had been vaccinated. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines would radically improve the economic outlook once they have been widely administered; it may allow GDP to rise to its pre-virus level a year earlier than otherwise and mean that the unemployment rate peaks at 7% next year instead of 9%.
- **Public borrowing** is now forecast by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the Government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.
- Overall, the **pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. It is likely that the one month national lockdown that started on 5th November, will have caused a further contraction of 8% month on month in November so the economy may have then been 14% below its pre-crisis level.
- **December 2020 / January 2021**. Since then, there has been rapid back-tracking on easing restrictions due to the spread of a new mutation of the virus, and severe restrictions were imposed across all four nations. These restrictions were changed on 5 January 2021 to national lockdowns of various initial lengths in each of the four nations, as the NHS was under extreme pressure. It is now likely that wide

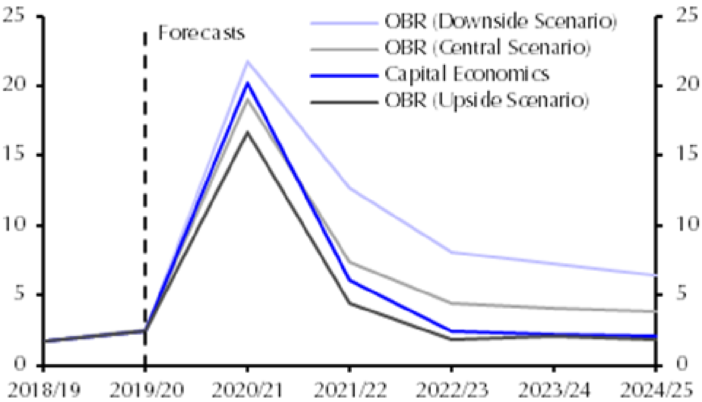
swathes of the UK will remain under these new restrictions for some months; this means that the near-term outlook for the economy is grim. However, the distribution of vaccines and the expected consequent removal of COVID-19 restrictions, should allow GDP to rebound rapidly in the second half of 2021 so that the economy could climb back to its pre-pandemic peak as soon as late in 2022. Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant caveat is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)




- This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade would have major repercussions for public finances as it would be consistent with the Government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assume that there is a reasonable Brexit deal and also that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

Chart: Public Sector Net Borrowing (As a % of GDP)



- There will still 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, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a reversal of globalisation as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, digital services are one area that has already seen huge growth.
- **Brexit**. While the UK has been gripped by the long running saga of whether or not a deal would be made by 31 December 2020, the final agreement on 24 December, followed by ratification by Parliament and all 27 EU countries in the following week, has eliminated a significant downside risk for the UK economy. The initial agreement only covers 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. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.
- **Monetary Policy Committee meeting of 17 December**. All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, "Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case." So, while the vaccine is a positive development, in the eyes of the MPC at least, the economy is far from out of the woods. As a result of these continued concerns, the MPC voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30 April until 31 October 2021. (The MPC had assumed that a Brexit deal would be agreed.)
- **Fiscal policy**. In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy:
    - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
    - The furlough scheme was lengthened from the end of March to the end of April.
    - The Budget on 3 March 2021 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).
- The **Financial Policy Committee** (FPC) report on 6v August 2020 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%.

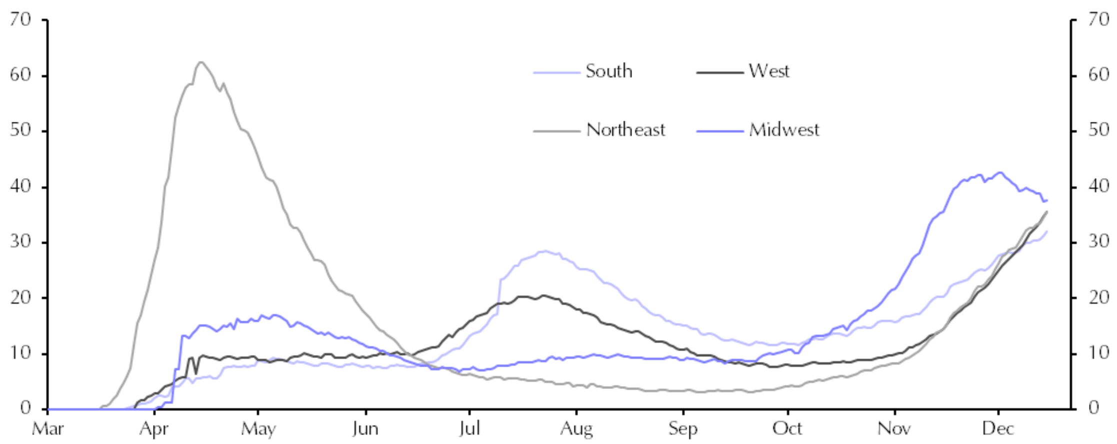
**USA**

- The result of **the November elections** means that the Democrats have gained the presidency and a majority in the House of Representatives, and the winning of the two Senate seats in Georgia on 6 January mean they will hold a slim majority in the Senate. This means that the Democrats should be able to do a massive fiscal stimulus, as they had been hoping to do after the elections. That would result in another surge of debt issuance and could put particular upward pressure on debt yields – which could then also put upward pressure on gilt yields.

- Equity prices leapt up on 9 November on the first news of a successful vaccine and have risen further during November as more vaccines announced successful results. This could cause a big shift in investor sentiment i.e. a swing to sell out of Government debt to buy into equities which would normally be expected to cause debt prices to fall and yields to rise. However, the rise in yields has been quite muted so far and it is too early to say whether the Fed would feel it necessary to take action to suppress any further rise in debt yields. It is likely that the next two years, and possibly four years in the US, could be a political stalemate where neither party can do anything radical.

- The economy had been recovering quite strongly from its contraction in 2020 of 10.2% due to the **pandemic** with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a third wave. While the first wave in March and April was concentrated in the Northeast, and the second wave in the South and West, the latest wave has been driven by a growing outbreak in the Midwest. The latest upturn poses a threat that the recovery in the economy could stall. This is **the single biggest downside risk** to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, states might feel it necessary to return to more draconian lockdowns.

COVID-19 hospitalisations per 100,000 population




- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and retail sales dropping back. The economy is set for further weakness in December and into the spring. However, a $900bn fiscal stimulus deal passed by Congress in late December will limit the downside through measures which included a second round of direct payments to households worth $600 per person and a three-month extension of enhanced unemployment insurance (including a $300 weekly top-up payment for all claimants). GDP growth is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- 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. 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.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that inflation will only get back to 2.0% in 2023, the vast majority expect the fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. 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 low – which will also have an influence on gilt yields in this country.

**EUROZONE**

- In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has affected many countries: it is likely to hit hardest those countries more dependent on tourism. The €750bn 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 the countries most affected by the first wave.
- With inflation expected to be unlikely to get much above 1% over the next two years, the **ECB** has been struggling to get inflation up to its 2% target. 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 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 Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. 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. However, as in the UK and the US, the

advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

**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. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies.
- 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 in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

**JAPAN**

- A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the Government's latest fiscal effort should help 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 will have been in recession in 2020. 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.
- 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 depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese Government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. 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. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

**SUMMARY**

- Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand in their economies.
- If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

**Appendix F**

## INTEREST RATE FORECASTS

**Brexit.** The interest rate forecasts provided by Link were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31 December 2020. There is therefore no need to revise these forecasts now that a trade deal has been agreed. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID-19 crisis.

**The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- 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.

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

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand in the economy.
- **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 agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next two or three years. 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

will 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, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. 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.

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

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- 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 rapid series of increases in Bank Rate to stifle inflation.