



APPENDIX 1

SCOTTISH BORDERS COUNCIL

**TREASURY MANAGEMENT MID-YEAR REPORT
2020/21**

1. BACKGROUND

a) Treasury management is defined as:

“The management of the local authority’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.

b) The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing security and adequate liquidity, before considering optimising investment return.

c) The second main function of the treasury management service is the funding of the Council’s capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, where favourable conditions exist, any debt previously drawn may be restructured to meet Council risk or cost objectives.

d) **Annex A** contains a summary of the updated Prudential and Treasury Management Indicators for 2020/21 as highlighted throughout this report.

2 ECONOMIC POSITION

2.1 ECONOMIC UPDATE (from Link Asset Services)

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

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

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

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

In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the “medium-term projections were a less informative guide than usual” and the minutes had multiple references to **downside risks**, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1st November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid September.

Overall, **the pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.

There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.

One key addition to **the Bank’s forward guidance** was a new phrase in the policy statement, namely that “it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably”. That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years’ time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate.

The **Financial Policy Committee (FPC)** report on 6th August revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

US. The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to

abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked **its inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e. following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary “trap” like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC’s updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

EU. The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.

China. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

Japan. There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

World growth. Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

2.2 INTEREST RATE FORECAST

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

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

Additional notes by Link on this forecast table: -

- *Please note that we have made a slight change to our interest rate forecasts table above for forecasts for 3, 6 and 12 months. Traditionally, we have used LIBID forecasts, with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that all LIBOR rates up to 6 months are currently running below 0.1%, using that convention would give negative figures as forecasts for those periods. However, the liquidity premium that is still in evidence at the short end of the curve, means that the rates actually being achieved by local authority investors are still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 0.05% is achievable for 3 months, 0.1% for 6 months and 0.15% for 12 months.*
- *During 2021, Link will be continuing to look at market developments in this area and will monitor these with a view to communicating with clients when full financial market agreement is reached on how to replace LIBOR. This is likely to be an iteration of the overnight SONIA rate and the use of compounded rates and Overnight Index Swap (OIS) rates for forecasting purposes.*
- *If clients require forecasts for 3 months to 12 months beyond the end of 2021, a temporary fix would be to assume no change in our current forecasts.*

We will maintain continuity by providing clients with LIBID investment benchmark rates on the current basis.

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6th August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

GILT YIELDS / PWLB RATES. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low

levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply. At the close of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

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

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

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

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will

take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.
- 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** - second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**. The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for “weaker” countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021**. In the German general election of September 2017, Angela Merkel’s CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.

- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks**, for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- **US – the Presidential election in 2020**: this could have repercussions for the US economy and SINO-US trade relations.

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

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

3 TREASURY MANAGEMENT POLICY STATEMENT - UPDATE

- a) The Treasury Management Policy Statement (the Statement) was approved by Council in April 2010. There have been no policy changes to the Statement. The details in this report update the position in light of updated economic position and budgetary changes.
- b) Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by Council on 27 February 2020. There are no further policy changes to the Statement. The details in this report provides an update on Treasury Management activities, including Prudential and Treasury Management Indicators.

4 COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2020/21

4.1 This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

4.2 CAPITAL EXPENDITURE *(Prudential Indicator (PI-1))*

- a) The original capital plan for 2020/21 was approved on 27 February 2020. **Table 2** shows the current budgets for capital expenditure compared to the original estimates used in the Treasury Management Strategy report for 2020/21.

Table 2	2020/21 Original Budget	2020/21 Current Approved Budget ¹	Variance Original to Current Approved
	£m	£m	£m
Assets & Infrastructure	41.0	38.9	(2.1)
Other Corporate Services	1.9	8.8	6.9
Children & Young People	20.5	7.2	(13.3)
Culture & Sport	1.3	1.0	(0.3)
Economic Regeneration	15.9	9.4	(6.5)
Housing Strategy & Services	0.5	0.3	(0.2)
Social Care Infrastructure	5.0	2.0	(3.0)
Emergency & Unplanned Schemes	0.2	0.6	0.4
Total Capital Expenditure (PI-1)	86.3	68.2	(18.1)

¹ Executive Committee 17 November 2020

- b) The current approved budget for 2020/21 is less than the original budget mainly due to adverse timing movements as a result of the impact of COVID-19, partly offset by the acceleration of digital transformation. Detailed explanations of the movements within the planned expenditure have been reported in the ongoing monitoring reports, the last of which was to the Executive Committee on 17 November 2020. The key drivers for the 2020/21 changes in Table 2 are:

- Assets & Infrastructure - reduction to budget as a result of timing movements between financial years for the Hawick Flood Protection Scheme.
- Other Corporate Services budget - increased by £6.9m due to timing movements between financial years in ICT and Digital Learning Transformation.
- Children & Young People – reduction of £13.3m due to budget movement into 2021/22 (£9.5m) and 2022/23 (£3.0m) for new school builds, as well as a re-direction of resources to ICT transformation.
- Economic Regeneration – the reduction in budget reflects a timing movement between financial years for the Central Borders Business Park.
- Social Care Infrastructure – decrease due to the removal of works from the draft financial plan.

4.3 FINANCING OF THE CAPITAL PROGRAMME

- a) **Table 3** on the following page draws together the main funding elements of the capital expenditure plans (see 4.2 above), comparing the original components of the funding strategy to those of the latest approved budget for the 2020/21 capital programme.

Table 3	2020/21 Original Budget	2020/21 Current Approved Budget ¹	Variance Original to Current Approved
	£m	£m	£m
Capital Expenditure (PI-1)	86.3	68.2	(18.1)
Other Relevant Expenditure	-	-	-
Total Expenditure	86.3	68.2	(18.1)
<i>Financed by:</i>			
Capital receipts	(2.4)	(3.5)	(1.1)
Capital from Revenue (CFCR)	-	(0.6)	(0.6)
Developer Contributions	(0.2)	(0.2)	-
Govt. General Capital Grant	(11.1)	(10.7)	0.4
Govt. Specific Capital Grant	(21.1)	(16.2)	4.9
Other Grants & Contributions	(13.0)	(8.1)	4.9
Replacement Funds	(2.4)	(2.5)	(0.1)
Total Financing	(50.2)	(41.8)	8.4
Net Financing Need for the Year	36.1	26.4	(9.7)

¹ Executive Committee 17 November 2020

- b) The decrease in overall financing need is primarily driven by the reduced projected capital expenditure as detailed in table 2, above. The impact on net financing need by this decrease in expenditure of £18.1m in total, has been primarily off-set by a smaller reduction in Scottish Government Specific Grants of £4.9m, principally relating to Hawick Flood Protection Scheme (carried forward to future years); along with a £4.9m decrease in Other Grants & Contributions which mainly relates to the Central Borders Business Park (carried forward to 2021/22).

4.4 CAPITAL FINANCING REQUIREMENT AND EXTERNAL DEBT INDICATORS

CAPITAL FINANCING REQUIREMENT (CFR) (PI-2)

- i) **Table 4** below shows the CFR, which is the underlying need to incur external borrowing for a capital purpose.
- ii) The CFR has been re-calculated in light of the changes to the capital plan and the fixed asset and reserve valuations in the Council's accounts for the year ending 31 March 2020; this has resulted in a variance of £12.2m in the CFR.

Table 4	2020/21 Original estimate £m	2020/21 Revised estimate £m	Variance £m
CFR * (PI-2)	374.6	362.4	12.2

The CFR for this calculation includes current capital expenditure assumptions to 30 September 2020.

ACTUAL EXTERNAL DEBT (PI-5)

- iii) Projected external debt for 2020/21 is shown in **Table 5** below and is estimated to remain within the operational boundary.
- iv) **Table 5** also compares the current projected external borrowing estimate with the estimate in the Annual Strategy. In cash terms, the borrowing figure is lower than originally projected

in line with the reduced net financing need as detailed above. A variance in cash levels held at the year-end compared to those projected also impact on the variance below.

- v) Due to the overall financial position and the effect of COVID-19 on the capital programme, there has been no new external borrowing undertaken so far this year. It is anticipated that borrowing of £10m will be undertaken during the remainder of this financial year.

Table 5	2020/21 Original estimate	2020/21 Current Approved Budget	Variance
	£m	£m	£m
Borrowing	224.9	212.0	(12.9)
Other long-term liabilities	97.8	97.6	(0.2)
Total External Debt (PI-5)	322.7	309.6	(13.1)

(UNDER)/OVER BORROWING AGAINST CFR (PI-6)

- vi) A key control over treasury activity is a prudential indicator to ensure that, over the medium term, borrowing will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2020/21 and next two financial years. This allows some flexibility for limited early borrowing for future years.
- vii) **Table 6** compares the prudential indicator for (under)/over borrowing against CFR versus the updated estimate for the year end and shows that the Council's actual debt levels are well within its capital financing requirement. This is primarily driven by the tactical measures which use the Council's surplus cash-flows to finance capital expenditure minimising the need enter into additional debt financing arrangements.

Table 6	2020/21 Original estimate	2020/21 Current Approved Budget	Variance
	£m	£m	£m
Gross External Debt	322.7	309.6	(13.1)
CFR *	444.8	448.0	(3.2)
(Under)/Over Borrowing against CFR (PI-6)	(122.1)	(138.4)	(16.3)

* The CFR for this calculation includes the current and two future years projected capital expenditure.

- viii) No difficulties are envisaged for the current or future years in complying with this prudential indicator.

AUTHORISED LIMIT AND OPERATIONAL BOUNDARY (PI-7 and PI-8)

- ix) Two further prudential indicators control the overall level of borrowing. These are:
- (i) The **Authorised Limit** which represents the limit beyond which borrowing is prohibited and the expected maximum borrowing need for the Council. It needs to be set and revised by Members. The Authorised Limit is the statutory limit determined under the Local Government in Scotland Act 2003.
 - (ii) The **Operational Boundary** which shows the expected operational debt position for the period.

- x) **Table 7** below shows revised estimates for the debt indicators for the 2020/21 financial year and compares them with the original estimates shown in the 2020/21 Treasury Management Strategy Report.

Table 7	2020/21 Original estimate £m	2020/21 Revised estimate £m	Variance £m
Gross External Debt (PI-5)	322.7	309.6	13.1
Authorised Limit inc. Long Term Liabilities(PI-8a)	498.1	501.1	(3.0)
<i>Variance to External Debt Estimate</i>	<i>175.4</i>	<i>191.5</i>	<i>(16.1)</i>
Operational Boundary inc. Long Term Liabilities (PI-7a)	415.1	417.6	2.5
<i>Variance to External Debt Estimate</i>	<i>92.4</i>	<i>108.0</i>	<i>(15.6)</i>

4.5 DEBT RESCHEDULING

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

5 INVESTMENT ACTIVITY

5.1 INVESTMENTS

- a) In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As shown by the interest rate forecasts in section 2.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low.
- b) The Council held £39.4m of balances in interest bearing accounts as at 30 September 2020 (£8.6m at 31 March 2020). As a result of current market uncertainties, the Council has been prioritising the security of deposits by investing surplus balances with money market funds and the UK Government's Debt Management Office (DMO).
- c) The increase in the level of balances invested from March to September, highlighted above are due to timing differences between the receipt of grant funding and corresponding capital expenditure, detailed in section 4.4 above, along with the advance receipts of COVID-19 related grant funding.
- d) The Council, due to the cashflow position and the requirement to manage the Pension Fund cash as well as the Council's, continues to explore opportunities to invest surplus balances in the short term.

Negative investment rates

- e) While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid crisis; this has caused some local authorities to have sudden large increases in investment balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.
- f) As for money market funds (MMFs), yields have continued to drift lower. Some managers have suggested that they might resort to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a glut of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions.
- g) Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Creditworthiness.

- h) Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks made provisions for *expected* credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on *actual* levels of credit losses. (Quarterly performance is normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". They stated that in their 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%.
- i) All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades.
- j) Link have conducted some stress testing on the Link credit methodology based list of counterparties supplied to clients, to test for the results of a 1 notch downgrade to all Long Term Ratings from all agencies. Under such a scenario, only Commerzbank, Norddeutsche Landesbank, NatWest Markets Plc (non-ring-fenced entity), Leeds, Skipton and Yorkshire Building Societies moved from Green to No Colour. While there are a further 17 drops in

other entities' suggested durations, in these instances, these entities still remain potentially available for use. (Note that this scenario excludes any additional impact from relative movement in CDS pricing.)

5.2 INVESTMENT COUNTERPARTY CRITERIA

- a) The current investment counterparty criterion, approved in the Treasury Management Strategy, represents a prudent approach to risk and the Council's concerns about security of investments. These prudent limits mean there are limited investment options when operating the cash-flow on a short term management basis.
- b) Considering security, liquidity and yield of investment, priority is given to security. Daily updates and reports are received from Link Asset Services that allow officers to assess the continued credit worthiness of investment counter parties.
- c) All investments undertaken are on a short term, highly liquid basis, allowing access to invested funds at 1 days notice.
- d) Interest rates are also monitored on a daily basis to ensure the best return is obtained. Target for internal return on cash investment is to be above the 7 Day LIBID rate. The return for six months to 30 September 2020 has averaged 0.17%, compared against an average seven day LIBID rate of $-(0.06)\%$.

LOAN CHARGES

- a) The **Loan Charges** Revenue Budget estimate contained in the Council's Financial Plans approved on 26 February 2020 was £19.111m. It is expected that charges for 2020/21 will be lower than the budgeted figure, in line with the actual and projected borrowing requirements for the year.

ANNEX A

Indicator Reference	Indicator	Page Ref.	2020/21 Original estimate	2020/21 Revised estimate
PRUDENTIAL INDICATORS				
Capital Expenditure Indicator				
PI-1	Capital Expenditure Limits (£m)	8	86.3	68.2
PI-2	Capital Financing Requirement (£m) (CFR)	9	374.6	362.4
Affordability Indicator				
PI-3	Ratio of Financing Costs to Net Revenue (inc PPP repayment costs)	N/A	8.9%	8.7%
PI-4	Incremental (Saving)/ Cost Impact of Capital Investment Decisions on Council Tax	N/A	£(0.03)	£(0.00)
External Debt Indicators				
PI-5	External Debt (£m)	10	322.7	309.6
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	11	415.1	417.6
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	N/A	317.3	319.9
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	11	498.1	501.1
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	N/A	400.4	403.5
Indicators of Prudence				
PI-6	(Under)/Over Net Borrowing against the CFR (£m)	10	(122.1)	(138.4)
TREASURY INDICATORS				
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)		415.1	417.6
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)		145.3	146.2
TI-3	Maturity Structure of Fixed Interest Rate Borrowing		Lower	
	Under 12 months		0%	
	12 months to 2 years		0%	
	2 years to 5 years		0%	
	5 years to 10 years		0%	
	10 years and above		20%	
TI-4	Maximum Principal Sum invested greater than 364 days	12	20%	20%