**Appendix B - Treasury Management Strategy Statement (TMSS) 2019/20**

## Introduction

Treasury management is the management of the Council’s cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council’s prudent financial management.

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy’s *Treasury Management in the Public Services: Code of Practice (2017 Edition)* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council’s legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

In addition, the Ministry of Housing, Communities and Local Government (MHCLG) has revised its *‘Capital Finance: Guidance on Minimum Revenue Provision (Fourth Edition)’* in 2018, although this has not impacted the Council’s existing methodology for calculating Minimum Revenue Provision (MRP). Further details in relation to MRP are outlined at Appendix D.

Investments held for service purposes or for commercial profit are considered in a separate report, the Investment Strategy.

## External Context

**Economic background:** The UK’s progress in negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council’s treasury management strategy for 2019/20.

The UK economy expanded by 0.4% for the three months to 31 October 2018. Expectations are for Q4 Gross Domestic Product (GDP) growth of around 0.3% which would put 2018 overall at around 1.3%, the weakest rate since the financial crisis. The annual Consumer Price Index (CPI) measure of inflation was 2.4% as at the end of October 2018, unchanged from 2.4% in September 2018. Inflation is likely to remain above the Bank of England’s Monetary Policy Committee (MPC) 2.0% target over much of the next three years. The labour market saw the unemployment rate for the three months to 31 October 2018 at 4.1%, unchanged from the rolling average annual figure reported in the previous quarter but lower than 4.3% a year earlier.

The Monetary Policy Committee (MPC) meets on a monthly basis to set the Bank of England's Base Rate, which is used to control the level of inflation. The MPC aims for a target CPI inflation rate of 2.0%, within a range of plus or minus 1.0%, i.e., between 1.0% and 3.0%.

The Bank of England's MPC voted unanimously to maintain its Base Rate at its meeting in November 2018 at 0.75%. A relatively weak economic environment limits the speed of any further rises in the Base Rate, although the Bank is of the view that it will "need to raise interest rates a bit more over the next few years". The long term neutral level of Base Rate is considered by the Bank to be between 2% and 3%.

As the US economy has continued to perform well, the Federal Reserve maintained its monetary tightening stance and pushed up its target range for the Fed Funds Rate in September 2018 by 0.25% to 2.0% - 2.25%. One further rise is expected in 2018 and two more in 2019.

The European Central Bank (ECB) is expected to maintain key ECB interest rates at their present levels at least through the summer of 2019. However, it has been tapering its Quantitative Easing (QE) programme which it intends to end in December 2018 and has signalled to markets to expect an interest rate increase in 2019.

**Credit outlook**: The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

**Interest rate forecast**: Following the increase in Base Rate to 0.75% in August 2018, the Council's treasury management adviser, Arlingclose, is forecasting two more 0.25% increases during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that a higher Base Rate will be a more effective policy weapon should downside Brexit risks crystallise, when rate cuts will be required.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.5% and 2% respectively over the interest rate forecast horizon. However, volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at *Schedule 1*.

For the purpose of setting the 2019/20 budget, it has been assumed that new investments will be made at an average rate of 1.0%, and that new short-term loans will be borrowed on an average variable interest rate of 1.3% based on the forecast prevailing Base Rate plus a prudent allowance for uncertainty and brokerage fees.

## Local Context

At 30 November 2018, the Council held £319.5M of borrowing and £29.3M of investments. This is set out in further detail at *Schedule 2.* Forecast changes in these sums are shown in the Balance Sheet analysis in Table 1 below.

**Table 1: Balance Sheet Summary and Forecast**

| | **31/3/18 Actual £M** | **31/3/19 Estimate £M** | **31/3/20 Estimate £M** | **31/3/21 Estimate £M** | **31/3/22 Estimate £M** |
|---|---|---|---|---|---|
| General Fund CFR | 354.3 | 371.2 | 408.6 | 434.0 | 435.6 |
| HRA CFR | 164.9 | 164.9 | 169.9 | 179.9 | 189.9 |
| **Total CFR** | **519.2** | **536.1** | **578.5** | **613.9** | **625.5** |
| Less: Other long-term liabilities * | (16.5) | (15.7) | (15.3) | (14.9) | (14.1) |
| **Borrowing CFR** | **502.7** | **520.4** | **563.2** | **599.0** | **611.4** |
| Less: External borrowing ** | 301.7 | 275.5 | 275.5 | 275.5 | 230.5 |
| **Internal borrowing** | **201.0** | **244.9** | **287.7** | **323.5** | **380.9** |
| Less: Usable reserves | 138.4 | 96.2 | 70.6 | 67.4 | 67.7 |
| Less: Working capital | 62.6 | 50.0 | 50.0 | 50.0 | 50.0 |
| **New borrowing** *** | **0.0** | **(98.7)** | **(167.1)** | **(206.1)** | **(263.2)** |

* PFI liabilities form part of the Council's debt

** shows only loans to which the Council is committed and excludes optional refinancing

*** forecast borrowing is based on the full Capital Programme being achieved.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves are the underlying resources available for investment. However, usable reserves include school balances, those specific to the Housing Revenue Account (HRA) and other earmarked reserves. The usable General Fund reserves balance as at 31 March 2018 was £15.6M.

The Council has an increasing CFR due to the Capital Programme and continues to adhere to its long-standing strategy of holding low cash balances to reduce investment counterparty risk and contain its borrowing costs by utilising cash balances in lieu of borrowing externally. The Balance Sheet summary in Table 1 shows that the Council's extent of internal borrowing was £201.0M as at 31 March 2018. The Council uses internal resources in lieu of borrowing to the full extent as this has continued to be the most cost-effective means of funding capital expenditure.

CIPFA's *Prudential Code for Capital Finance in Local Authorities (2017 Edition)* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this in the medium term.

## Borrowing Strategy

At 30 November 2018, the Council held external borrowing of £319.5M. The Balance Sheet forecast in Table 1 shows that it is estimated that the net borrowing CFR will increase by £17.7M in 2018/19, from £502.7M to £520.4M.

**Objectives:** The primary objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

**Strategy:** Given the significant reductions in public expenditure and in particular local government funding, the borrowing strategy continues to address the key issue of affordability without compromising the longer term stability of the debt portfolio. With short-term interest rates currently much lower than long term rates, it is likely to be more cost effective in the short term to either use internal resources, or to borrow using short term fixed rate loans instead.

By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing and short term fixed rate loan finance will be monitored regularly against the potential for incurring additional costs when long term borrowing rates are forecast to rise modestly. Arlingclose will assist with this 'cost of carry' calculation and breakeven analysis. The output may determine whether the Council considers borrowing additional sums at long term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short term.

**Sources of borrowing:** The approved sources of long-term and short-term borrowing are:

- the Public Works Loan Board (PWLB) and any successor body
- UK local authorities
- police and fire bodies
- other public bodies such as Police and Crime Commissioners
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public sector pension funds (except Bedfordshire Pension Fund)
- special purpose companies created to enable joint local authority bond issues
- capital market bond investors.

The Council and its predecessors raised the majority of the long-term borrowing from the PWLB. The Council plans to maintain minimal cash levels for operational purposes to minimise investment counterparty risk and source its borrowing needs from other UK local authorities, police and fire authorities, Police and Crime Commissioners, and UK public sector pension funds on a short term rolling basis. This strategy is expected to achieve significant revenue cost savings over the more traditional route of long term fixed rate borrowing from the PWLB.

The revenue implications of the Capital Programme over 2019/20 to 2022/23 have been calculated on the assumption that most new borrowing will be taken on a short term fixed rate basis taking advantage of current low levels of interest rates. This borrowing strategy is based on an assumption that the current Base Rate of 0.75% will be subject to two more 0.25% increases during 2019 to take official UK interest rates to 1.25%, which continues to be significantly below what is considered to be the Bank of England's long term neutral level of Base Rate of between 2% and 3%. However, the Council will continue to monitor long term rates with a view to fixing a portion of its borrowing if rates are favourable.

There is a risk that interest rates may increase or be higher than current rates when it comes to refinancing debt taken out on a short-term basis. This would lead to higher revenue implications arising from the draft Capital Programme over the longer term, beyond the current Medium Term Financial Plan (MTFP) period. However, interest rate risk is preferable to credit risk which is minimised through the use of short term fixed rate borrowing to enable the Council to maintain minimal operational cash balances.

**LOBOs:** The Council holds two LOBO (Lender's Option Borrower's Option) loans totalling £13.5M where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. These two LOBOS have options during 2019/20, and although the Council understands that the lender is unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at low cost if it has the opportunity to do so.

**Short term fixed rate and variable rate loans:** These leave the Council exposed to the risk of short term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

**Debt rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, where this is expected to lead to an overall saving or a reduction in risk.

## Investment Strategy

At 30 November 2018, the Council held £23.7M of invested funds, (excludes an external investment in the Aviva Investors' Lime Property Fund Unit Trust valued at £5.6M as at 30 November 2018). Over the past 12 months, the investment balance which is determined by reference to the Council's day-to-day cash flow requirements has ranged between £5M and £41M. The Council plans to maintain minimum cash levels for operational purposes in the forthcoming year.

**Objectives:** The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

**Strategy:** Given the increasing risk and very low returns from short-term unsecured bank deposits, the Council aims to effectively manage this risk by maintaining minimum cash levels for operational purposes and diversifying investments between several counterparties to mitigate the impact of any bail-in of unsecured investments. Local authority investments in bank call/notice accounts, deposits and Money Market Funds (MMFs) are unsecured investments.

The Council may invest its surplus funds with any of the counterparties in Table 2 below:

**Table 2: Approved Investment Counterparties**

<table>
<tr><th colspan="2">Counterparty</th></tr>
<tr><td rowspan="8">Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:</td><td>AAA</td></tr>
<tr><td>AA+</td></tr>
<tr><td>AA</td></tr>
<tr><td>AA-</td></tr>
<tr><td>A+</td></tr>
<tr><td>A</td></tr>
<tr><td>A-</td></tr>
<tr><td>BBB+</td></tr>
<tr><td colspan="2">UK Central Government (irrespective of credit rating)</td></tr>
<tr><td colspan="2">UK Local Authorities, Police and Fire bodies, other public bodies such as Police and Crime Commissioners, and UK public sector pension funds (irrespective of credit rating)</td></tr>
<tr><td colspan="2">Money market funds and other pooled funds</td></tr>
</table>

**Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

**Registered providers**: Registered providers of social housing and registered social landlords are tightly regulated by the Regulator of Social Housing and retain the likelihood of receiving Government support if needed. The Council will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

**Pooled funds:** Shares or units in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds (MMFs) that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. They offer enhanced returns over the longer term, but are potentially more volatile in the shorter term, and their performance and continued suitability in meeting the Council's investment objectives need be monitored regularly. The Council has one pooled fund, investing in UK commercial property, inherited from one of the legacy councils (the "Lime Fund"). This investment is monitored regularly with our treasury management adviser, Arlingclose, and continues to meet the Council's investment objectives. There are no plans currently to invest further in pooled funds.

**Operational bank accounts**: The Council's current accounts are held with NatWest which is currently rated at the minimum BBB+ (or Moody's equivalent of Baa1) rating in Table 2. Should the credit ratings fall below BBB+, the Council may continue to deposit surplus operational cash with NatWest providing that the cash can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (or Moody's equivalent of Baa3) which is the lowest investment grade rating. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion (NatWest Markets plc had net assets as at 31 December 2017 of £35 billion) are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

**Risk assessment and credit ratings**: Credit ratings are obtained and monitored by the Council's treasury adviser, Arlingclose, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made;
- any existing investments that can be recalled or sold at no cost will be; and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the minimum BBB+ rating, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

**Other information on the security of investments**: The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

**Investment limits**: The Council's General Fund revenue reserve available to cover investment losses is forecast to be £15.6M on 31 March 2019. In order that no more than £7M of the available reserve will be put at risk in the case of a single bank default, the maximum that will be lent to any one organisation (other than the UK Government and other public bodies referenced in Table 3) will be £7M. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

**Table 3: Investment Limits**

| | **Cash limit** |
|---|---|
| Any single organisation, except the UK Central Government | £7M each |
| UK Central Government (irrespective of credit rating) | unlimited |
| UK Local Authorities, Police and Fire bodies, other public bodies such as Police and Crime Commissioners, and UK public sector pension funds (irrespective of credit rating) | unlimited |
| Any group of organisations under the same ownership | £7M per group |
| Any group of pooled funds under the same management | £10M per manger |
| Negotiable instruments held in a broker's nominee account | £10M per broker |
| Foreign countries | £10M per country |
| Registered providers and social landlords | £10M in total |
| Unsecured investments with Building Societies | £10M in total |
| Loans to small businesses | £10M in total |
| Loans to subsidiaries and partly-owned companies | £10M in total |
| Money Market Funds | 70% in total |

**Liquidity management**: Cash flow forecasting is used to determine the maximum period for which funds may prudently be committed. Limits on long term investments are set by reference to the Council's Medium Term Financial Plan and cash flow forecast.

## Treasury Management Indicators

**Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures, expressed as the proportion of net principal borrowed will be:

**Table 4: Limits on Fixed and Variable Rate Exposures**

| | Actual fixed and variable rate borrowing as at 30/11/2018 % | 2018/19 % | 2019/20 % | 2020/21 % | 2021/22 % |
|---|---|---|---|---|---|
| Upper limit on fixed rate exposure | 76 | 100 | 100 | 100 | 100 |
| Upper limit for variable rate exposure | 24 | 50 | 50 | 50 | 50 |

The Council is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the Council. For example, a rise in interest rates would increase the revenue cost of borrowings at variable rates. The Council has a number of strategies for managing interest rate risk and aims to keep a maximum of 50% of its borrowings in variable rate loans during 2019/20.

**Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be,

| Refinancing rate risk indicator | Actual Borrowing as at 30/11/2018 % | Upper Limit % | Lower Limit % |
|---|---|---|---|
| Under 12 months | 26 | 50 | 0 |
| 12 months and within 24 months | 3 | 50 | 0 |
| 24 months and within 5 years | 0 | 60 | 0 |
| 5 years and within 10 years | 20 | 100 | 0 |
| 10 years and within 20 years | 31 | 100 | 0 |
| 20 years and within 30 years | 0 | 100 | 0 |
| 30 years and above | 20 | 100 | 0 |

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment, e.g., LOBO option dates (on which the lender can require payment) are treated as potential repayment dates.

**Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

| | 2019/20 | 2020/21 | 2021/22 |
|---|---|---|---|
| Limit on principal invested beyond year end | £10M | £10M | £10M |

* The Council holds an investment in Aviva Investors' Lime Property Fund Unit Trust (valued at £5.6M as at 30 November 2018). This investment has delivered a reasonably stable dividend income return of around 4% p.a. over recent years and the Council intends to retain this investment for the long term. However, it does not feature in the above Actual column on the basis that it does not have a specified maturity date and could be liquidated within an estimated 3-month timescale if necessary.

## Related Matters

The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

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

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

**Policy on Apportioning Interest to the HRA:** The Council has adopted a two pooled approach and all the costs/income arising from long-term loans will be either charged from or credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured and interest transferred between the General Fund and HRA based on a "risk free" rate sourced from HM Treasury's Debt Management Account Deposit Facility (DMADF).

**Markets in Financial Instruments Directive (MiFID):** The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Director of Resources believes this to be the most appropriate status.

## Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Resources, having consulted the Executive Member for Resources, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| Invest in a narrower range of counterparties and/or for shorter times | Interest income will be lower | Lower chance of losses from credit related defaults, but any such losses may be greater |
| Invest in a wider range of counterparties and/or for longer times | Interest income will be higher | Increased risk of losses from credit related defaults, but any such losses may be smaller |
| Borrow additional sums at long-term fixed interest rates | Debt interest costs will rise; this is unlikely to be offset by higher investment income | Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain |
| Borrow short-term or variable loans instead of long-term fixed rates | Debt interest costs will initially be lower | Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain |
| Reduce level of borrowing | Saving on debt interest is likely to exceed lost investment income. Unable to deliver the full Capital Programme. | Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain |

**Schedule 1 – Arlingclose Economic & Interest Rate Forecast**

**Underlying assumptions:**

- The Bank of England's Monetary Policy Committee (MPC) left Base Rate unchanged at its November 2018 meeting, after voting unanimously to increase Bank Rate to 0.75% in August.
- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long-term average. The UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.
- Cost pressures were projected to ease but have risen most recently and are forecast to remain above the Bank of England's 2% target through most of the forecast period. The rising price of oil and tight labour market means inflation may remain above target for longer than expected. This means that strong real income growth is unlikely in the near future.
- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider both that: 1) ultra-low interest rates result in other economic problems, and 2) higher Base Rate will be a more effective policy weapon should downside Brexit risks crystallise and cuts are required.
- The global economy appears to be slowing, particularly the Eurozone and China, where the effects of the trade war has been keenly felt. Despite slower growth, the European Central Bank (ECB) is adopting a more strident tone in conditioning markets for the end of QE, the timing of the first rate increase (2019) and their path thereafter. Meanwhile, European political issues, mostly lately with Italy, continue.
- The US economy is expanding more rapidly. The Federal Reserve has tightened monetary policy by raising interest rates to the current 2%-2.25% range; further rate hikes are likely, which will start to slow economic growth. Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

**Forecast:**

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, with two further hikes in 2019 taking the official Base Rate to 1.25%. The risks are weighted to the downside.

- Gilt yields have remained at low levels. Some upward movement is expected from current levels based on interest rate projections, the strength of the US economy and the ECB's forward guidance on higher rates. However, volatility arising from both economic and political events will continue to offer borrowing opportunities.

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | |
| Upside risk | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Arlingclose Central Ca | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 |
| Downside risk | 0.00 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| 3-mth money market rate | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.10 | 0.10 | 0.10 | 0.15 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 |
| Arlingclose Central Ca | 0.90 | 0.95 | 1.10 | 1.30 | 1.40 | 1.40 | 1.40 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 |
| Downside risk | 0.20 | 0.45 | 0.60 | 0.80 | 0.90 | 0.90 | 0.90 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 |
| 1-yr money market rate | | | | | | | | | | | | | |
| Upside risk | 0.20 | 0.30 | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 |
| Arlingclose Central Ca | 1.15 | 1.25 | 1.35 | 1.50 | 1.70 | 1.60 | 1.50 | 1.40 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 |
| Downside risk | 0.35 | 0.50 | 0.60 | 0.80 | 0.90 | 0.90 | 0.90 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 |
| 5-yr gilt yield | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Arlingclose Central Ca | 1.15 | 1.25 | 1.35 | 1.50 | 1.50 | 1.40 | 1.35 | 1.35 | 1.30 | 1.30 | 1.30 | 1.30 | 1.30 |
| Downside risk | 0.50 | 0.60 | 0.65 | 0.80 | 0.80 | 0.70 | 0.65 | 0.65 | 0.65 | 0.65 | 0.65 | 0.65 | 0.65 |
| 10-yr gilt yield | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Arlingclose Central Ca | 1.50 | 1.65 | 1.70 | 1.80 | 1.80 | 1.75 | 1.75 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 |
| Downside risk | 0.55 | 0.70 | 0.70 | 0.80 | 0.80 | 0.75 | 0.75 | 0.70 | 0.70 | 0.70 | 0.70 | 0.70 | 0.70 |
| 20-yr gilt yield | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Arlingclose Central Ca | 2.00 | 2.10 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 |
| Downside risk | 0.60 | 0.70 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |
| 50-yr gilt yield | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Arlingclose Central Ca | 1.90 | 1.95 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Downside risk | 0.60 | 0.70 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%

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

## Schedule 2 – Existing Investment & Debt Portfolio Position

| | 30/11/18<br>**Actual Portfolio**<br>**£M** |
|---|---|
| **External Borrowing:** | |
| PWLB – Fixed Rate | 217.0 |
| PWLB – Variable Rate | 45.0 |
| LOBO Loans | 13.5 |
| Local Government Loans | 27.5 |
| **Total External Borrowing** | **303.0** |
| **Other Long-Term Liabilities:** | |
| Private Finance Initiative (PFI) | 16.5 |
| **Total Gross External Debt** | **319.5** |
| **Investments:** | |
| *Internally managed funds:* | |
| Short term investments | 23.7 |
| *Externally managed funds:* | |
| Pooled Funds *(Lime Fund)* | 5.6 |
| **Total Investments** | **29.3** |
| **Net Debt** | **290.2** |