Mayor and Cabinet

Treasury Management Mid-Year Review 2020/21

Date: 11 November 2020

Key decision: No.

Class: Part 1.

Ward(s) affected: None specifically

Contributors: Director of Corporate Resources

Outline:

The purpose of this report is to set out the following:

- An economic update for the first half of the 2020/21 financial year;
- A review of the Treasury Management Strategy;
- An update on the Council's capital expenditure programme and prudential indicators;
- A review of the Council's investment portfolio for 2020/21;
- A review of the Council's borrowing strategy for 2020/21; and
- A review of compliance with treasury and prudential limits for 2020/21.

Recommendation:

Mayor and Cabinet are recommended to:

1. Agree to change the Council's 2020/21 Investment Strategy to exclude the UK from the minimum sovereign rating requirement of AA-; and

2. Note the report, in particular the macroeconomic updates, performance of investments to date, updates on capital expenditure and borrowing in line with the Chartered Institute of Public Finance and Accountancy's (CIPFA) prudential indicators, and compliance with the Council's Treasury Management Strategy.

Timeline of engagement and decision-making:

26 February 2020 – Budget Report to Council (Section 10: Treasury Management Strategy)

1. Executive Summary

1.1. This report sets out the current economic conditions in which the Council is operating in respect of its investments and borrowing. It details the Council's treasury performance (focused on security, liquidity and return in that order) and forecast capital position as at 30 September 2020, and provides updates on performance against the current Treasury Management Strategy as required by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice.

1.2. The outbreak of coronavirus in March 2020 and the global response in implementing lockdowns and coordinating economic support packages has created an unprecedented and prolonged period of economic and fiscal uncertainty, the impact of which is likely to be felt for years to come. In the UK, despite a sharp recovery from April through to August, the second half of 2020/21 is likely to show no growth, and as the second wave of the virus spreads throughout Europe downside risks will likely persist in both the short and medium term, including:

- The pace and scale of any future changes to the UK Bank Rate;
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows;
- A resurgence of the Eurozone debt crisis; and
- UK/EU trade negotiations causing significant economic disruption and a fresh major downturn in the rate of growth.

1.3. In terms of Council performance, the overall capital expenditure estimate for 2020/21 has decreased from £194m per the February 2020 Budget Report to £164m as at 30 September 2020, which is in large part due to the coronavirus pandemic causing work to stall across a number of schemes as well as longer term slippage. Although the General Fund programme is forecast to spend £5m more than originally budgeted, capital expenditure against the Housing Revenue Account (HRA) is expected to decrease by approximately £35m.

1.4. As a result of these amendments there have been changes to the financing sources to be used for the programme. The General Fund schemes are forecast to receive more in grants and contributions and make less use of reserves, whilst the HRA schemes will make use £89.6m of reserves and revenue to finance HRA expenditure in lieu of the £88.6m of prudential borrowing originally forecast.

1.5. The Council's Operational Boundary (being the limit which external debt is not normally expected to exceed) and Authorised Limit (being the limit beyond which borrowing is prohibited) have not been breached in the year to date, and no difficulties are envisaged for the current or future years in complying with the Code's requirements for prudential borrowing.

1.6. Council investments are managed within the agreed parameters and delivered an annualised average yield for the six months to 30 September 2020 of 0.61% (compared to 0.98% at September 2019). With interest rates continuing to fall, it is likely that the final 2020/21 yield will fall short of the 0.95% achieved in 2019/20. However, for the risk profile inherent in the portfolio, current performance exceeds modelled yield and is in line with a wider benchmark group of London authorities.

1.7. As a result of ongoing market uncertainty there is a risk that the UK's sovereign rating, currently at AA-, will fall below that allowed by the existing Treasury Management Strategy. With almost 70% of the Council's treasury portfolio currently invested in UK institutions it is proposed for Mayor and Cabinet's approval that the minimum sovereign rating requirement is removed for the UK only. Individual institutions would remain subject to the usual creditworthiness checks as per the 2020/21 Investment Strategy.

2. Recommendations

2.1. Mayor and Cabinet are recommended to:

2.1.1. Agree to change the Council's 2020/21 Investment Strategy to exclude the UK from the minimum sovereign rating requirement of AA-; and

2.1.2. Note the report, in particular the macroeconomic updates, performance of investments to date, updates on capital expenditure and borrowing in line with the Chartered Institute of Public Finance and Accountancy's (CIPFA) prudential indicators, and compliance with the Council's Treasury Management Strategy.

3. Policy Context

3.1. The Council's 2018 to 2022 Corporate Strategy identifies seven corporate priorities and four core values which are the driving force behind what we do as an organisation. It sets out a vision for Lewisham and priority outcomes that organisations, communities and individuals can work towards to make this vision a reality.

3.2. In taking action to implement and review the Council's treasury management function, with the overriding objective to achieve security, maintain adequate liquidity, and seek yield in line with the Council's risk appetite, we will be driven by the Council's four core values:

- We put service to the public first;
- We respect all people and all communities;
- We invest in employees; and
- We are open, honest and fair in all we do.

3.3. These core values align with the Council's seven corporate priorities, as follows:

- **Open Lewisham** - Lewisham is a welcoming place of safety for all where we celebrate the diversity that strengthens us.
- **Tackling the housing crisis** - Everyone has a decent home that is secure and affordable.
- **Giving children and young people the best start in life** - Every child has access to an outstanding and inspiring education, and is given the support they need to keep them safe, well and able to achieve their full potential.
- **Building an inclusive local economy** - Everyone can access high quality job opportunities, with decent pay and security in our thriving and inclusive local economy.
- **Delivering and defending health, social care and support** - Ensuring everyone receives the health, mental health, social care and support services they need.
- **Making Lewisham greener** - Everyone enjoys our green spaces and benefits from a healthy environment as we work to protect and improve our local environment.
- **Building safer communities** - Every resident feels safe and secure living here as we work together towards a borough free from the fear of crime.

4. Structure of the Report

4.1. The remainder of this report is structured as follows:

5. Background and Prior Year Outturn

5.1. The Council is required to operate a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return. The onset of the coronavirus pandemic has led to unprecedented levels of economic and fiscal uncertainty, making a balanced budget even more challenging to achieve than in the previous years of austerity.

5.2. 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, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

5.3. Accordingly, treasury management is defined 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."

5.4. The Council complies with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). The primary requirements of the Code are as follows:

a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

c) Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

e) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Public Accounts Select Committee.

a) Capital Strategy

5.5. In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2020/21, all local authorities have been required to prepare a Capital Strategy which is to provide the following:

- A high-level 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; and
- The implications for future financial stability.

5.6. The 2020/21 Capital Strategy was approved by Council on 26 February 2020.

b) 2019/20 Treasury Management Outturn

5.7. The overall treasury management outturn for the year ending 31 March 2020 is set out in the table below:

Treasury Management Outturn 2019/20	Outstanding at 31 March 2020	Average Coupon Rate	Average Remaining Duration	Outstanding at 31 March 2019
	£m	%	Years	£m
Fixed Rate Borrowing				
Public Works Loan Board	96.7	4.5	20.3	96.7
Market Loans	82.5	4.1	34.0	82.5
Subtotal – Fixed Rate Borrowing	***179.2***	***4.3***	***22.6***	***179.2***
Variable Rate Borrowing				
Public Works Loan Board	0.0	0.0	0.0	0.0
Market Loans	37.8	2.2	38.3	38.0
Subtotal – Variable Rate Borrowing	***37.8***	***2.2***	***38.3***	***38.0***

Treasury Management Outturn 2019/20	Outstanding at 31 March 2020	Average Coupon Rate	Average Remaining Duration	Outstanding at 31 March 2019
	£m	%	Years	£m
Total Debt	**217.0**	**4.0**	**23.0**	**217.2**

Fixed Rate Investments				
Banks and Building Societies	175.0	1.01	157 (days)	260.0
Local Authorities	13.0	1.15	269 (days)	0.0
Subtotal – Fixed Rate Investments	***188.0***	***1.01***	**168 (days)**	***260.0***
Variable Rate Investments				
Money Markets	114.7	0.72	N/A	82.4
Notice Accounts	80.0	1.09	156 (days)	80.0
Subtotal – Variable Rate Investments	***194.7***	***0.88***	***156 (days)***	***162.4***
Total Investments	**382.7**	**0.95**	**166 (days)**	**422.4**

5.8. In respect of the net borrowing requirement for 2019/20 was £40.7m, this being £36.3m higher than the net borrowing requirement of £4.4m for 2018/19 as set out in the table below:

Net Borrowing Requirement	2019/20 £m	2018/19 £m
Capital Investment	73.3	39.0
Capital Grants	(15.7)	(10.8)
Capital Receipts	(9.7)	(2.5)
Revenue	(3.0)	(13.3)
Net position	***(44.9)***	***(12.4)***
MRP	(4.0)	(5.8)
Maturing Debt	(0.2)	(2.2)
Net Borrowing Requirement	**40.7**	**4.4**

5.9. The main reason for this was the progress made with the acquisition of temporary accommodation to support the Council's social housing supply priority. In previous years the Council has financed its net borrowing requirement from temporary cash balances it holds. As at 31 March 2020, this internal borrowing was estimated to be £74.7m, which is the difference between the Capital Financing Requirement (CFR) and the Council's actual borrowing – see calculation at 8.9 below. If the effect of the 'Adjustment A' entry is removed (which is a technical accounting adjustment designed to ensure consistency in calculating the Minimum Revenue Provision (MRP) from the old to the revised system of capital controls introduced in April 2004), the estimated internal borrowing at 31 March 2020 reduces to £33.1m.

Debt and CFR Movement	2019/20 £m	2018/19 £m
Capital Financing Requirement*	291.7	250.9
External Debt**	(217.0)	(217.2)

Debt and CFR Movement	2019/20 £m	2018/19 £m
Difference – Internal Borrowing	***74.7***	***33.7***

* Excluding other long term liabilities.

**Excluding Fair Value adjustments.

6. Economic Update

6.1. The Economic update is provided by the Council's treasury advisors Link Assets Services and is at Appendix 3; this includes commentary on the impact of coronavirus on global markets.

a) Interest Rate Forecasts

6.2. The Council's treasury adviser, Link Asset Services, has published its latest interest rate forecasts up to 31 March 2023 as below:

	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%	0.05%	0.05%	0.05%	0.05%	0.05%
6 Month average earnings	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
12 Month average earnings	0.15%	0.15%	0.15%	0.15%	0.15%	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%

6.3. The coronavirus outbreak has caused huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut the Bank Rate to first 0.25%, and then to 0.10%, it left the Bank Rate unchanged at its meeting on 6 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 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 the Bank Rate is expected within the forecast horizon up to 31 March 2023 as economic recovery is expected to be gradual and, therefore, prolonged.

6.4. The PWLB rates shown in the table are at the discounted certainty rate, being 180 basis points above gilt yields, available to qualifying local authorities. 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.

b) Balance of Risks to the UK

6.5. The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the coronavirus. There is relatively little UK domestic risk of increases or decreases in the 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 the 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.

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

- The scale and pace of the second UK nationwide wave of coronavirus infections and extent of further economic restrictions from lockdown measures;
- UK/EU trade negotiations causing significant economic disruption and a fresh major downturn in the rate of growth;
- The Bank of England taking action too quickly, or too far, over the next three years to raise the Bank Rate, causing UK economic growth, and increases in inflation, to be weaker than currently anticipated;
- A resurgence of the Eurozone debt crisis;
- Weak growth or recession in the UK's main trading partners, the EU and US;
- Weak capitalisation of some European banks, which could be undermined further depending on the extent of credit losses resultant of the pandemic;
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows; and
- The US presidential election, which could have repercussions for the US economy and SINO-US trade relations.

6.7. Upside risks to current forecasts for UK gilt yields and PWLB rates include:

- A stronger than currently expected recovery in the UK economy with the likelihood of a successful vaccine;
- The potential for a post-Brexit agreement being reached that removes the majority of threats of economic disruption between the EU and the UK; and
- The Bank of England is too slow in its pace and strength of increases in the Bank Rate, therefore allowing inflationary pressures to build up too strongly within the UK economy which then necessitates a later rapid series of increases in the Bank Rate faster than currently expected.

7. Treasury Management Strategy and Annual Investment Strategy Update

7.1. The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by

Council on 26 February 2020.

7.2. In mid-October 2020 Moody's, one of the main credit rating agencies and one of three used by the Council to determine creditworthiness as part of its Annual Investment Strategy, downgraded the UK's sovereign rating one notch from Aa2 to Aa3. This was a direct response to the UK's diminishing economic and fiscal strength, and the agency's view that the UK's institutions and their governance has weakened in recent years.

7.3. The downgrade moves the agency in line with the AA- Fitch rating, with Standard and Poor's (S&P) still rating the UK one notch higher with an AA rating. The Council's current investment strategy sets out an approved list of countries in which it can invest, all of which must have a minimum sovereign rating of AA-/Aa3 or higher.

7.4. Given the extraordinary economic and fiscal environment caused by the coronavirus outbreak, and the ongoing uncertainty over the outcome of Brexit negotiations, the risk of further downgrades to the UK's sovereign rating cannot be predicted with any certainty. Should such a downgrade take place, not only would the Council's existing investments in UK institutions be in breach of the investment strategy but the available options for the investment of those funds upon maturity would be extremely limited.

7.5. At 30 September 2020 almost 70% of the Council's investment portfolio is invested within the UK. Officers therefore consider it prudent to consider a revision to the existing investment strategy, and recommend that the UK be excluded from the minimum sovereign rating requirement of AA-, which would allow the Council to continue to invest in UK banks and building societies should its sovereign rating fall below AA-.

7.6. It should be noted that no changes are proposed to the existing creditworthiness policy, whereby individual institutions must still meet certain credit criteria before being considered for investment, and remain subject to existing financial and maturity limits. Even if the UK's sovereign rating were to fall below AA-, there remains the risk that some UK banks and building societies will also be downgraded and fall outside the Council's lending criteria; however, such an event would not prove as restrictive to the security and liquidity of funds as not being able to invest in the UK at all.

8. Capital Position (Prudential Indicators)

8.1. This section of the report is structured to update on:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of any 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.

a) Prudential Indicator for Capital Expenditure

8.2. The table below shows the original estimates for capital expenditure in 2020/21 as agreed by Council in February 2020 and the latest revised estimates.

Capital Expenditure	Original Feb 20 £m	Revised Sep 20 £m	Change £m	Change %
General Fund				
Schools – Pupil Places and Other Capital Works	10.9	10.3	(0.6)	(6%)
Highways, Footways and Bridges	3.3	4.8	1.5	45%
Regeneration Schemes	12.2	26.5	14.3	117%
Lewisham Homes Property Acquisition	3.0	0.0	(3.0)	(100%)
Town Centres and High Street Improvements	3.7	1.0	(2.7)	(73%)
Asset Management Programme	7.5	2.4	(5.1)	(68%)
Fleet Replacement Programme	8.1	7.8	(0.3)	(4%)
Beckenham Place Park	0.6	0.7	0.1	17%
Residential Portfolio Acquisition	0.0	2.9	2.9	N/A
Other Schemes	8.8	6.8	(2.0)	(23%)
Subtotal	***58.1***	***63.2***	***5.1***	***9%***
Housing Revenue Account				
HRA	136.3	100.4	(35.9)	(26%)
Total	**194.4**	**163.6**	**(30.8)**	**(16%)**

8.3. The overall capital programme has been reduced down from £194.4m to £163.6m, largely as a result of the coronavirus pandemic causing work to stall across a number of schemes and longer term slippage expected to occur.

8.4. The General Fund's revised capital expenditure forecast at September 2020 has increased by £5.1m, or 9%, from the position reported in the February budget report, with material adjustments to several forecasts throughout the programme.

- Within the overall schools programme the estimated spend on school places has decreased from £10.5m to £4.7m, whilst estimated spend on the schools minor works programme has increased from £0.1m to £3.9m;
- The overall increase of £14.3m on regeneration schemes is in most part due to the inclusion of £14.8m expected spend on Phase 2 of the Lewisham Gateway development; and
- The reduction of £5.1m in planned spend against the asset management programme is largely due to a re-phasing of 2020/21 expenditure on various schemes to later years.

8.5. The HRA reduction of £35.9m includes several material movements; the estimated spend on the Housing Matters Programme has reduced from £97.5m to £36.5m due to delays and uncertainty caused by the coronavirus outbreak, the Decent Homes Programme has increased by £10m, and new estimates have been made for the Creekside acquisition (£5.7m), Ladywell Leisure Centre Development (£4.5m) and the Achilles Street Development (£4.3m).

b) Financing of the Capital Programme

8.6. The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure in 2020/21. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). If the CFR is positive, the Council may borrow from the PWLB or the market (external borrowing), or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions

8.7. This direct borrowing need may also be supplemented by maturing debt and other treasury requirements. The table below shows a reduction of £91.2m in the amount of prudential borrowing required to meet the revised capital programme; this is the result of slippage due to the coronavirus pandemic, uncertainty about the timing and extent of economic recovery and future funding streams, and changing priorities/shifts in ways of working highlighted by the pandemic.

Capital Expenditure Financing	Original Feb 20 £m	Revised Sep 20 £m	Change £m	Change %
Grants and contributions	36.4	44.6	8.2	23%
Capital Receipts	5.6	2.6	(3.0)	(54%)
General reserves / revenue	43.9	99.1	55.2	126%
Subtotal	***85.9***	***146.3***	***60.4***	***70%***
Borrowing Required	108.5	17.3	(91.2)	(84%)
Total	**194.4**	**163.6**	**(30.8)**	**(16%)**

c) Limits to Borrowing Activity

8.8. The first key control over treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) is only undertaken for capital purposes. Gross 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. The Council's policy is not to borrow more than or in advance of its needs purely in order to profit from the investment of the additional sums borrowed. Any decision to borrow in advance will be within the approved CFR estimates and will be utilised if it is deemed to be prudent.

8.9. The forecast gross debt position for the end of 2020/21 has changed from that reported in the February Budget due to an expected decrease in the external debt balance. This is partly a result of delays to the capital programme caused by the coronavirus outbreak but also due to a change in financing for HRA capital expenditure, with reserves and revenue contributions replacing previously planned prudential borrowing. With a corresponding decrease in the CFR, the forecast over/under borrowing position for 2020/21 is an under-borrowed position of £51.7m, as shown in the below table.

	2019/20 Actual £m	2020/21 Forecast (as per February 2020 Budget) £m	2020/21 Forecast (as at 30 September 2020) £m
External Debt at 1 April	217.2	225.1	217.0

	2019/20 Actual £m	2020/21 Forecast (as per February 2020 Budget) £m	2020/21 Forecast (as at 30 September 2020) £m
Change in External Debt	(0.2)	86.6	36.3
Other Long-Term Liabilities*	228.1	229.2	219.2
Gross Debt at 31 March	**445.1**	**540.9**	**472.5**
Capital Financing Requirement at 31 March*	**519.8**	**632.5**	**524.2**
Borrowing – Over / (Under)	**(74.7)**	**(91.6)**	**(51.7)**

*Includes on balance sheet PFI schemes.

8.10. The CFR forecast for 2020/21, which is the underlying external need to incur borrowing for a capital purpose, has decreased since it was reported in February's Budget. This largely reflects the decrease in the underlying prudential borrowing figures. The final actuals for 2020/21, as well as forecasts for 2021/22 to 2023/24, will be presented with the 2021/22 Treasury Management Strategy in February 2021.

8.11. A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit, which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It includes 'on balance sheet' PFI schemes and finance leases as well as external borrowing, and is the expected maximum borrowing need with some headroom for unexpected movements. It is also a statutory limit determined under section 3 (1) of the Local Government Act 2003. The level for 2020/21 was originally forecast at £596.9m and agreed by Council as part of the Treasury Management Strategy in February 2020.

8.12. The table below shows the updated Operational Boundary forecast for 2020/21 as at 30 September 2020, which is the limit that external debt is not normally expected to exceed, and how this compares to the approved 2020/21 Authorised Limit. Mid-year forecasts indicate that the approved 2020/21 Operational Boundary exceeds current requirements due to the expected reduction in 2020/21 external debt, and as such the Authorised Limit is also expected to exceed final outturn; as such, no request is made in this report to increase the Limit.

	2019/20 Actual £m	2020/21 (as per February 2020 Budget) £m	2020/21 Forecast (as at 30 September 2020) £m
Maximum External Debt at 31 March	217.0	311.7	253.3
Other Long-Term Liabilities	228.1	229.2	219.2
Operational Boundary for the Year	**445.1**	**540.9**	**472.5**
Provision for Non Receipt of Expected Income	56.0	56.0	56.0
Authorised Limit for Year	**501.1**	**596.9**	**528.5**

8.13. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30 September 2020, the Council has operated within the prudential indicators set out in the Treasury Management Strategy for 2020/21. The Executive Director for Corporate Resources reports that although no difficulties are envisaged for the current or future years in complying with the prudential indicators, officers will closely monitor adherence to the limits for the remainder of the year. Approval will be sought when necessary to amend the indicators to reflect the authority's developing capital programme.

9. Investment Portfolio 2020/21

9.1. 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. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information. As set out in Section 6, 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 the 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 the Bank Rate are unlikely to occur before the end of the current forecast horizon of 31 March 2023, investment returns are expected to remain extremely low.

a) Negative Interest Rates

9.2. Whilst the Bank of England has indicated it is unlikely to introduce a negative Bank Rate, at least in the short term, 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 significant access to credit, either directly or through commercial banks. In addition, the Government has provided grants to local authorities to help deal with the coronavirus crisis. This has caused some local authorities to have sudden large increases in investment balances, some of which was only very short term until those sums were able to be passed on.

9.3. Money Market Fund (MMF) yields have continued to drift lower. Some managers have suggested 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, has resulted in a glut of money moving around at the very short end of the market pushing rates into negative territory; inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home. However, MMFs are still offering a marginally positive return, as are a number of financial institutions.

b) Performance as at 30 September 2020

9.4. The Council held £385m of investments as at 30 September 2020 (£383m at 31 March 2020) and the portfolio annualised yield for the first six months of the year is 0.61% (compared to 0.98% for the same period last year). These investments provide some assurance when matched to the level of debt held, represent the reserves held for investment, and provide the working balances and cash flow to support the Council's service delivery.

9.5. The Council is a member of a treasury benchmarking group (organised by Link Asset Services) containing 15 authorities, including 12 other London authorities. An extract from the latest available benchmarking report is shown in Appendix 2; this shows that the return on investments as at June 2020 is above the Council's model weighted average rate of return provided by the treasury advisors, which is adjusted for the risks inherent in the portfolio. Portfolio performance is also in line with the overall benchmarking group, as well as a wider group of 20 London boroughs.

9.6. A full list of outstanding investments held as at 30 September is shown below:

Counterparty	Duration (Days)	Principal £m	Interest Rate	Interest £
Fixed Rate Investments – Banks and Building Societies				
Australia and New Zealand Banking Group	364	25.0	0.90%	224,384
Close Brothers Ltd	181	20.0	0.45%	44,630
DBS Bank Ltd.	364	15.0	0.95%	142,110
DBS Bank Ltd	186	5.0	0.28%	7,134
DBS Bank Ltd	273	5.0	0.24%	8,975
Goldman Sachs International Bank	185	5.0	0.90%	22,808
Landesbank Hessen-Thueringen	364	10.0	0.95%	94,740
Landesbank Hessen-Thueringen	364	10.0	0.84%	83,770
Lloyds Bank Plc (RFB)	364	5.0	1.05%	52,356
National Westminster Bank PLC (RFB)	364	10.0	1.00%	99,227
National Westminster Bank PLC (RFB)	274	10.0	0.92%	69,063
National Westminster Bank PLC (RFB)	364	10.0	0.30%	29,918
Norddeutsche Landesbank	91	15.0	0.18%	6,732
OP Corporate Bank plc	184	10.0	0.54%	27,222
Standard Chartered Bank	183	10.0	0.35%	17,548
Sumitomo Mitsui Banking Corporation	183	10.0	0.75%	37,603
Toronto-Dominion Bank	365	10.0	1.05%	105,000
Toronto-Dominion Bank	365	15.0	1.01%	151,500
Fixed Rate Investments – Local Authorities				
London Borough of Southwark	364	10.0	0.95%	94.740
London Borough of Hillingdon	364	5.0	0.32%	15,956
London Borough of Waltham Forest	364	3.0	0.30%	8,975
Variable Rate Investments – Money Markets				
Aberdeen Standard	N/A	30.0	0.08%	N/A
Federated Hermes	N/A	30.0	0.05%	N/A
Insight	N/A	24.2	0.01%	N/A
Variable Rate Investments – Notice Accounts				
Bank of Scotland Plc (RFB)	175	20.0	0.21%	N/A
Barclays Bank Plc (NRFB)	95	20.0	0.35%	N/A
Lloyds Bank Plc (RFB)	175	20.0	0.21%	N/A
Santander UK Plc	180	20.0	0.55%	N/A

9.7. The Executive Director of Corporate Resources confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2020/21.

9.8. The current investment counterparty criteria as set out in the Credit Worthiness Policy and included at Appendix 1 of this report are meeting the requirements of the treasury management function, although the current low rate environment and the reluctance of banks and building societies to accept new deposits reduces the available pool of counterparties that meet guideline investment rates.

10. Borrowing and Debt Rescheduling

10.1. The Council's latest forecast CFR for 2020/21 is £524.2m. As at 30 September 2020, the Council has external borrowings of £213m and has utilised an estimated £41m of cash in lieu of borrowing. This has proven to be a prudent and cost effective approach in the recent past, and in the current economic climate but will require ongoing monitoring in the event that any upside risk to gilt yields prevails.

10.2. No new external borrowing has been undertaken to date in 2020/21; the increase in PWLB margins over gilt yields in October 2019 and the subsequent consultation on these margins by HM Treasury, together with the impact of coronavirus on the capital programme, has led the Council to make use of internal borrowing where required this financial year. It is anticipated, however, that external borrowing will be undertaken later this financial year, and the borrowing strategy will be reviewed and then revised as necessary for the Treasury Management Strategy update in February 2021 in order to achieve optimum value and risk exposure in the long-term.

10.3. 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.

11. Financial Implications

11.1. There are no additional financial implications besides those mentioned elsewhere in this report.

12. Legal Implications

12.1. Local authorities are required to produce and monitor for the forthcoming year a range of indicators based on actual figures; these are set out in the report. The CIPFA Treasury Management Code of Practice says that movement may be made between the various indicators during the year by an Authority's Chief Finance Officer so long as the indicators for the total Authorised Limit and the total Operational Boundary for external debt remain unchanged. Any such changes are to be reported to the next meeting of the Council.

12.2. Under Section 5 of the Local Government Act 2003, the prudential indicator for the total Authorised Limit for external debt is deemed to be increased by an amount of any unforeseen payment which becomes due to the Authority within the period to which the limit relates, which would include, for example, additional external funding becoming available but not taken into account by the Authority when determining the Authorised Limit. Where Section 5 of the Act is relied upon to borrow above the Authorised Limit, the Code requires that this fact is reported to the next meeting of the Council.

12.3. Authority is delegated to the Executive Director of Corporate Resources to make amendments to the limits on the Council's counterparty list and to undertake treasury management in accordance with the CIPFA Code of Practice and the Council's Treasury Policies.

13. Equalities Implications

13.1. There are no direct equalities implications arising from this report.

14. Climate Change and Environmental Implications

14.1. There are no direct climate or environmental implications arising from this report.

15. Crime and Disorder Implications

15.1. There are no direct crime and disorder implications arising from this report.

16. Health and Wellbeing Implications

16.1. There are no direct health and wellbeing implications arising from this report.

17. Background Papers

17.1. The following papers are appended to this report:

- *Appendix 1 – Extract from Credit Worthiness Policy*
- *Appendix 2 – Benchmarking Extract*
- *Appendix 3 – Economic Update from Link Asset Services*

18. Report Author and Contact

18.1. For more information please contact David Austin, Director of Corporate Resources, 1st Floor Laurence House, 020 8314 9114, David.Austin@lewisham.gov.uk.

18.2. Financial implications: Robert Browning, Treasury accountant

18.3. Legal implications: Mia Agnew, Contracts lawyer

APPENDIX 1: Extract from Credit Worthiness Policy

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	**Maximum % of total investments / £ limit per institution**	**Maximum maturity period**
DMADF – UK Government	N/A	100%	6 months
UK Government gilts	UK sovereign rating	£20m	1 year
UK Government Treasury bills	UK sovereign rating	£60m	6 months
Money Market Funds - CNAV	AAA	£30m	Liquid
Money Market Funds - LVNAV	AAA	£30m	Liquid
Money Market Funds - VNAV	AAA	£30m	Liquid
Local authorities	N/A	£10m	1 year
Term deposits with banks and building societies	Yellow* Purple Blue Orange Red Green No Colour	£30m £25m £40m £25m £20m £15m Not for use	Up to 5 years Up to 2 years Up to 1 year Up to 1 year Up to 6 months Up to 100 days Not for use
CDs or corporate bonds with banks and building societies	Blue Orange Red Green No Colour	£40m £25m £20m £15m Not for use	Up to 1 year Up to 1 year Up to 6 months Up to 100 days Not for use
Call accounts and notice accounts	Yellow* Purple Blue Orange Red Green No Colour	£30m £25m £40m £25m £20m £15m Not for use	Liquid
Pooled asset funds		£50m	At least 5 years

*for UK government debt, or its equivalent, Constant Net Asset Value (CNAV) money market funds, and collateralised deposits where the collateral is UK Government debt.

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APPENDIX 2: Benchmarking Extract

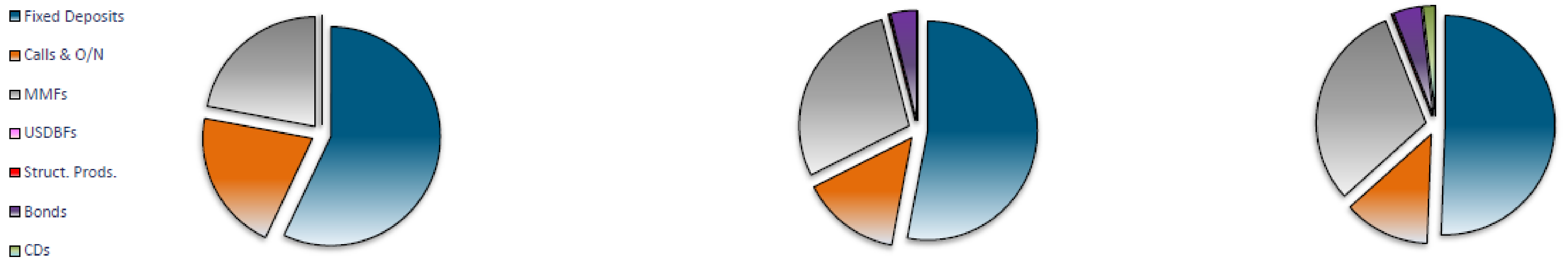
The following three pages present an extract, with glossary, of the Council's treasury benchmarking report as at 30 September 2020.

London Borough Of Lewisham

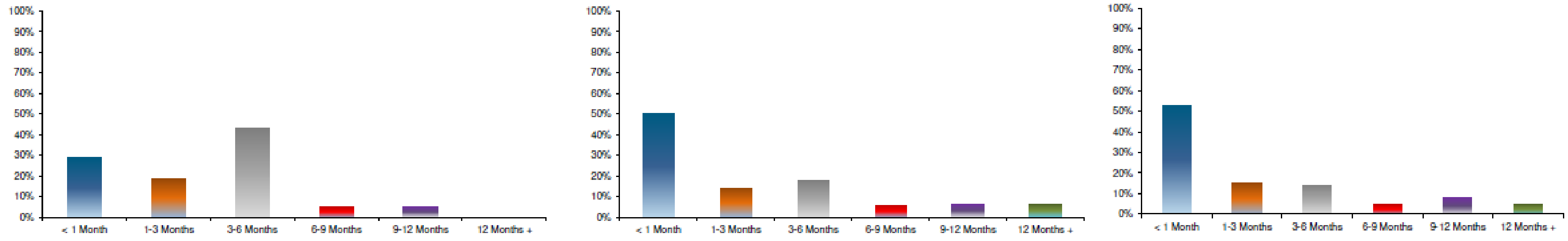
Summary Sheet

	London Borough Of Lewisham	Benchmarking Group 2 (14)	London (17)
Basic Portfolio Characteristics			
WARoR	0.49%	0.51%	0.48%
WAM	104	105	98
WATT	198	261	240
WA Credit Risk	3.42	2.37	2.27
Model WARoR	0.43%	0.54%	0.50%
Difference	0.06%	-0.03%	-0.02%
Model Band	0.35% - 0.52%	0.46% - 0.63%	0.42% - 0.59%
Performance	Inline	Inline	Inline

Asset Breakdown



Maturity Profiles



London Borough Of Lewisham

Peer Comparison

	London Borough Of Lewisham	Benchmarking Group 2 (14)		London (17)		Population Average (211)	
Basic Characteristics							
Principal	£382,192,000	£243,196,452		£200,245,124		£88,824,274	
WARoR	0.49%	0.51%		0.48%		0.34%	
WAM	104	105		98		71	
WATT	198	261		240		135	
WA Credit Risk	3.42	2.37		2.27		2.64	
Portfolio Breakdown							
Fixed Deposits	57.04%	52.99%	14	50.62%	16	38.70%	175
Calls & O/N	20.93%	14.57%	12	12.71%	13	27.31%	183
MMFs	22.03%	28.45%	14	30.67%	15	30.46%	168
USDBFs	0.00%	0.00%	0	0.00%	0	1.17%	10
Struct. Prods.	0.00%	0.14%	1	0.12%	1	0.24%	5
Bonds	0.00%	3.84%	1	4.12%	1	0.82%	9
CDs	0.00%	0.00%	0	1.77%	1	1.29%	20
Institution Breakdown							
Banks	73.26%	35.40%	14	32.14%	14	39.69%	191
Building Socs.	0.00%	2.73%	4	2.25%	4	4.36%	54
Government	4.71%	32.29%	10	34.01%	13	23.78%	134
MMFs	22.03%	28.45%	14	30.67%	15	30.46%	168
USDBFs	0.00%	0.00%	0	0.00%	0	1.17%	10
MLDBs	0.00%	0.00%	0	0.00%	0	0.00%	0
Other	0.00%	1.12%	2	0.92%	2	0.54%	12
Domestic/Foreign Exposure							
Domestic	46.57%	65.98%	14	64.75%	17	65.78%	203
Foreign	31.40%	5.56%	4	4.58%	4	2.60%	34
MMFs	22.03%	28.45%	14	30.67%	15	30.46%	168
USDBFs	0.00%	0.00%	0	0.00%	0	1.17%	10
Maturity Structure							
< 1 Month	28.57%	49.87%		52.54%		57.24%	
1-3 Months	18.32%	13.78%		15.16%		13.51%	
3-6 Months	43.17%	17.95%		14.24%		18.24%	
6-9 Months	5.23%	5.85%		4.82%		4.59%	
9-12 Months	4.71%	6.49%		8.25%		4.17%	
12 Months +	0.00%	6.06%		4.99%		2.25%	

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Definitions

WARoR	Weighted Average Rate of Return	This is the average annualised rate of return weighted by the principal amount in each rate.
WAM	Weighted Average Time to Maturity	This is the average time, in days, till the portfolio matures, weighted by principal amount.
WATT	Weighted Average Total Time	This is the average time, in days, that deposits are lent out for, weighted by principal amount.
WA Risk	Weighted Average Credit Risk Number	Each institution is assigned a colour corresponding to a suggested duration using Link Asset Services' Suggested Credit Methodology 1 = Yellow; 1.25 = Pink 1; 1.5 = Pink 2, 2 = Purple; 3 = Blue; 4 = Orange; 5 = Red; 6 = Green; 7 = No Colour
Model WARoR	Model Weighted Average Rate of Return	This is the WARoR that the model produces by taking into account the risks inherent in the portfolio.
Difference	Difference	This is the difference between the actual WARoR and the model WARoR; Actual WARoR minus Model WARoR.

APPENDIX 3: Economic Update from Link Asset Services

UK Economy

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

- The fall in GDP in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services, an area which was particularly vulnerable to being damaged by lockdown.

- The peak in the unemployment rate was revised down from 9% in Q2 to 7½% by Q4 2020.

- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI inflation to rise above the 2% target in Q3 2022 (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

1.2 It also quashed 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.

1.3 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.

1.4 In conclusion, this would indicate that the Bank could now just sit on its hands as the economy is 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.

1.5 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 1 November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid-September.

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

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

1.8 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 the 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 the Bank Rate.

1.9 The Financial Policy Committee (FPC) report on 6th August revised down its 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 Economy

1.10 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.

1.11 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.

1.12 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.

Eurozone Economy

1.13 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.

Asian Economy

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

1.15 In 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.

Global Growth Prospects

1.16 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.

Gilt Yields/PWLB Rates

1.17 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.

1.18 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.

1.19 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 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 30 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%.

1.20 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 9 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 11 March 2020, but not for mainstream General Fund capital schemes; at the same time, 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 4 June, but that date was subsequently put back to 31 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).

1.21 Following the changes on 11 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); and
- Local Infrastructure Rate is gilt plus 60bps (G+60bps).

1.22 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 unknown, although it would be likely to be within the current financial year.

Creditworthiness

1.23 Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30 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 noted that UK banks went into this pandemic with strong balance sheets.

1.24 All three ratings 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.

1.25 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 Credit Default Swap (CDS) pricing).

1.26 CDS prices, which are market indicators of credit risk, for UK banks spiked upwards at the end of March/early April due to the liquidity crisis throughout financial markets; prices have returned to more average levels since then, although they are still elevated compared to the end of February. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

END