REPORT TO:	**General Purposes and Audit Committee** **9 October 2019**
SUBJECT:	**Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review 2019/2020**
LEAD OFFICER:	**Nigel Cook , Head of Pensions Investment and Treasury**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Resources**
WARDS:	**All**

CORPORATE PRIORITY/POLICY CONTEXT:

This Report details the Council's Treasury Management activities during the first half of 2019/2020 and its compliance with the 2017 Prudential Code for Capital Finance. It also seeks the Committee's agreement to recommend to the Council an amendment to the Strategy in respect of the criteria for the inclusion of investment counterparties on the Council's list.

FINANCIAL SUMMARY:

This Report details the Council's Treasury Management activities during the first half of 2019/2020 and demonstrates its compliance with the 2017 Prudential Code for Capital Finance.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

1. RECOMMENDATIONS

The Committee are recommended to:

1.1 Note the contents of this report; and
1.2 Recommend to Council the adoption of revised lending list criteria as follows:

Specified investments

AAA rated money market funds - limit £20m
Debt Management Office – no limit
Royal Bank of Scotland – limit £25m

Non-specified investments

All institutions included on Link Asset Services' weekly "Suggested Credit List" (the Council's independent treasury advisors)– limit £10m
All UK local authorities – limit £10m
Duration to be determined by the "Suggested Credit List" of Link Asset Services.

2. EXECUTIVE SUMMARY

2.1 This Report is prepared in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) codes of practice in respect of capital finance and treasury management. These codes recommend that members are advised of treasury management activities of the first six months of each financial year and of compliance with various strategies and policies agreed by the Council. The report:

- Reviews compliance with the Treasury Management Strategy Statement, Capital Strategy and Annual Investment Strategy as agreed by Council on 4 March 2019 (Minute A20/17 applies);
- Reviews treasury borrowing and investment activity for the period 1 April 2019 to 30 September 2019;
- Demonstrates compliance with agreed Prudential Indicators and recommends revisions as appropriate; and
- Asks the Committee to recommend to the Council the adoption of revised lending list criteria

3 DETAIL

3.1 Background

3.1.1 In December 2017, CIPFA issued codes of practice as follows:

- The Prudential Code for Capital Finance in Local Authorities
- Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes

3.1.2 Under the former code of practice, from 2019/2020, all local authorities are 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;
- The implications for future financial sustainability.

3.1.3 As regards Treasury Management, the primary requirements of the Code are:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- 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.

- 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.
- 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 General Purposes and Audit Committee.

3.1.4 This mid-year report has been prepared in compliance with the codes and covers the following:

- An economic update for the first half of the 2019/20 financial year (Section 3.2);
- A medium term interest rates forecast (Section 3.3)
- A review of the Council's Treasury Management Strategy Statement and Annual Investment Strategy (Section 3.4);
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators (Section 3.5);
- A review of the Council's borrowing strategy (Section 3.6);
- A review of the Council's investment strategy (Section 3.7);
- A review of any debt re-scheduling undertaken (Section 3.8);

3.2 Economic update

3.2.1 A commentary provided by the Council's independent treasury advisers Link Asset Services (Link) in the first week of September 2019 is included as Appendix A.

3.3 Interest rate forecasts

3.3.1 Link have provided forecasts of key interest rates as detailed in Table 1. These inform decisions as to the timing and duration of borrowing decisions

Table 1: Interest Rate Forecasts

Link Asset Services Interest Rate View	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

3.3.2 A commentary by Link is included as Appendix B.

3.4 Treasury Management Strategy Statement and Annual Investment Strategy

3.4.1 The Treasury Management Strategy Statement and Annual Investment Strategy for 2019/2020 were approved by full Council on 4 March 2019 (Minute A20/17 refers).

3.4.2 In most regards the projections for the year remain appropriate. However:

- On 19 September 2019 Cabinet agreed to recommend to full Council revisions in borrowing limits arising from movements in the capital programme as discussed in Section 3.5 below; and
- This Committee is asked to recommend to full Council the adoption of revised lending list criteria as discussed in paragraph 3.7.8 below.

3.5 Capital Strategy and Prudential Indicators

3.5.1 Table 2 below shows the original capital budget as agreed by full Council on 4 March 2019 (Minute A19/17 applies) and the revised budget and the current estimated outturn reported to Cabinet on 19 September 2019. Members are advised to refer to this latter report for a commentary on these changes, found here: https://democracy.croydon.gov.uk/mgChooseDocPack.aspx?ID=1875

Table 2: Capital Expenditure by Services

Capital Expenditure by Service	Original Estimate £m	Revised Estimate £m	Outturn Projection £m
Health, Wellbeing and Adults		0.3	0.3
Children, Families and Education	35.6	49.9	35.7
Gateway, Strategy and Engagement	9.7	39.3	31.0
Place	77.8	126.4	103.2
Resources.	60.4	175.3	127.4
HRA	38.4	45.5	43.7
Total	**221.9**	**436.7**	**341.3**

The revisions to the revised estimate arise from slippage from 2018/2019 of £99.6m and re-profiling some schemes.

3.5.2 The table below details the funding sources of the capital programme. The borrowing element of the table increases the underlying need to borrow for capital purposes 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).

Table 3: Financing of Capital Expenditure

Financing of Capital Expenditure	Original Estimate £m	Revised Estimate £m	Outturn Projection £m
Capital receipts	2.5	23.3	23.3
Capital grants	41.8	46.9	37.5
Capital reserves	7.0		
Revenue	31.4	10.0	10.0
Total financing	**82.7**	**80.2**	**70.8**
Borrowing requirement	**139.2**	**356.5**	**270.5**

3.5.3 The key controls over treasury management activity are prudential indicators to ensure that, over the medium term, borrowing will only be for a 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 2019/20 and next two financial years. This allows some flexibility for limited early borrowing for future years. Full Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent. The table below shows changes in the CFR and borrowing requirements arising from the changes in the capital programme described above.

Table 4: Capital Financing Requirement

	Original Estimate* £m	Outturn Projection** £m
Borrowing	1,351.1	1,536.6
Other long term liabilities	84.9	82.8
Total debt	1,436.0	1,619.4
CFR (year-end position)	1,465.4	1,573.3

*As reported to full Council on 4 March 2019
**As reported to Cabinet on 19 September 2019

3.5.4 The Prudential Indicators relevant to the capital programme and its borrowing implications are the Operational Boundary (the expected debt position) and the Authorised Limit (the limit beyond which borrowing is prohibited). The table below shows amendments which, on 19 September 2019, Cabinet agreed to recommend to full Council.

Table 5: Key Prudential Indicators

	Original Estimate* £m	Outturn Projection** £m
Operational Boundary	1,436.0	1,655.3
Authorised Limit	1,486.0	1,705.3

*As reported to full Council on 4 March 2019
**As reported to Cabinet on 19 September 2019

3.5.5 Members will note that the Authorised Limit includes a buffer of £50m to cover unexpected cash flow shortages.

3.6 Borrowing Strategy

3.6.1 During 2019/2020 the Council has been operating in accordance with the borrowing limits approved by full Council on 4 March 2019. As discussed above, the current limits for the year are:

- Operational Boundary - £1,436m
- Authorised Limit - £1,486m

3.6.2 The level of the Council's borrowing, which is measured against the limits, was £1,357m on 1 April 2019 and subsequent borrowings of £80m have increased this to £1,437m.

3.6.3 Whilst the borrowing is still within the agreed limits the capital programme as proposed for the remainder of the year can only be financed if the limits as discussed in paragraph 3.5.4 are approved.

3.6.4 Borrowing will be taken up as required based on a continuing analysis of actual and projected expenditure over the different components of the capital programme and interest rates forecasts. It is likely that the Council will use a mixture of long term borrowing from the PWLB, short term borrowing from other local authorities and internal balances. Borrowing will be undertaken to fit into the Council's existing debt maturity profile to move towards a more even distribution of maturities. Appendix C shows the movements in PWLB interest rates for various loan periods during the last six months.

3.6.5 The Council's effective interest payable on long term debt currently stands at 3.14%.

3.7 Investment Strategy

3.7.1 From time to time, under Section 15 (1) of the Local Government Act 2003 the Secretary of State issues statutory guidance on local government investments to which local authorities are required to "have regard." This guidance was taken into account in the investment policy parameters set within the Council's Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Strategy as approved by full Council on 4 March 2019 Minute A20/17 applies).

3.7.2 The current guidance defines investments as "Specified" and "Non-specified".

3.7.3 An investment is a specified investment if all of the following apply:

- the investment and any associated payments or repayments are denominated in sterling;
- the investment has a maximum maturity of one year;
- the investment is not defined as capital expenditure; and
- the investment is made with a body or in an investment scheme described as high quality or with the UK Government, a UK local authority or a parish or community council.

3.7.4 A non-specified investment is any investment that does not meet all the conditions in paragraph 3.7.3 above.

3.7.5 It is the Council's priority when undertaking treasury activities to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. Investment instruments identified for use by the Council during 2019/2020 as advised in the current Treasury Management Strategy are detailed in Appendix D.

3.7.6 As set out in the Treasury Management Strategy (Appendix D), the criteria for the selection of counterparties for investments are based on formal credit ratings issued by Fitch Ratings and supplemented by additional market data such as rating outlooks, the pricing of credit default swaps (CDs) and bank share prices. In addition to the Fitch rated institutions all UK local authorities and some public bodies comprise the Council's Approved Lending List.

3.7.7 Each week, the Council, along with other clients, receives from Link a "Suggested Credit List." This is accompanied by a disclaimer reminding recipients, inter alia, as follows:

> *This document is intended for the use and assistance of customers of Link Asset Services. It should not be regarded as a substitute for the exercise by the recipient of its own judgement.*

3.7.8 Notwithstanding this and other similar clauses Link are the largest suppliers of treasury management advisory services to UK local authorities and understand the market well. In their analysis they take into account the views of each of the three major credit ratings agencies along with the pricing of credit default swaps and market intelligence. They are better placed than Council officers to carry out this analysis and it is therefore recommended that the Council amend the Treasury Management Strategy by the adoption of the following revised lending list criteria:

Specified investments

AAA rated money market funds - limit £20m
Debt Management Office – no limit
Royal Bank of Scotland – limit £25m
Duration of up to one year.

Non-specified investments

All institutions included on Link Asset Services' weekly "Suggested Credit List" – limit £10m
All UK local authorities – limit £10m
Duration to be determined by the "Suggested Credit List" from Link

3.7.9 The most recent list provided by Link (20 September 2019) is attached as Appendix E. (Please note that this Appendix is restricted under Paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

3.7.10 As regards investment returns, Link advise as follows:

"As shown by forecasts in section 3.3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The

continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low".

3.7.11 Investment activity in the first half of 2019/2020 conformed to the approved strategy. The Council has experienced no liquidity issues .with an average monthly balance of £89m being maintained in temporary investments. Part of this sum is made up of core balances such as provisions and reserves set aside and cash balances that can, if necessary, be invested for longer periods to take advantage of favourable interest rates and to limit exposure to the risk of future rate movements.

3.7.12 The Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2019/2020.

3.8 Repayment of Debt and Debt Rescheduling

3.8.1 With Public Works Loans Board rates low during the first half of 2019/2020 and with high premiums being attached to the premature repayment of existing debt, opportunities for debt restructuring were minimal and none were taken.

4 FINANCIAL CONSIDERATIONS

4.1 There are no further financial considerations arising from this report.

5 LEGAL CONSIDERATIONS

5.1 The Head of Litigation and Corporate Law comments on behalf of the Director of Law and Governance that in relation to the Annual investment strategy, the Council is required to have regard to the Guidance is issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003 entitled "Statutory guidance on Local Government Investments 3rd Edition" which is applicable from and effective for financial years commencing on or after 1 April 2018. The recommendation to full Council would entail an amendment to the Treasury Management Strategy previously approved by Members in March 2019.

5.2 In addition, two codes of practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) contain investment guidance, which complements the Ministry of Housing Communities and Local Government (MHCLG) guidance. These publications are:

- Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes
- The Prudential Code for Capital Finance in Local Authorities

5.3 Local authorities are required to have regard to the current editions of the CIPFA codes by regulations 2 and 24 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended.

5.4 Under the provisions of Section 3(1) and (8) of the Local Government Act 2003, the Council shall determine and keep under review how much money it can afford to borrow, and the function of determining and keeping these levels under review is a reserved function of Full Council.

5.4 In determining the Annual Minimum reserves and the policy around such reserves, the Council shall have regard to the Guidance issued by the Secretary of State under Section 21(1A) of the Local Government Act 2003 entitled "Statutory guidance on minimum revenue provision"

Approved by Sandra Herbert, Head of Litigation and Corporate Law on behalf of the Director of Law and Governance & Deputy Monitoring Officer

6 OTHER CONSIDERATIONS

6.1 Other than the considerations referred to above, there are no Customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

7. DATA PROTECTION IMPLICATIONS

7.1 Will the subject of the report involve the processing of 'personal data'?

No.

Has a data protection impact assessment (DPIA) been completed?

No. This report relates to financial markets, treasury management, and debt and investments.

Approved by: Lisa Taylor, Director of Finance, Investment and Risk, S151 Officer

---

CONTACT OFFICER: Nigel Cook, Head of Pensions Investment and Treasury, Finance, Investment and Risk Resources Department, ext. 62552.

APPENDICES:

A – Economic update
B – Interest rate forecast update
C – PWLB rates
D – Investment instruments

E – Suggested credit list (Part B – restricted under Paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972.)

APPENDIX A

Economic update (as prepared by Link Asset Services in the first week of September 2019)

UK. This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, so far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing, (first week in September), the whole political situation in the UK over **Brexit** is highly fluid and could change radically by the day. The vote in the Commons on 3 September looks likely to lead to a delay in the date for Brexit to 31 January 2020, but there is also likelihood that there will be an imminent general election. In such circumstances, any interest rate forecasts are subject to material change as the situation evolves. At present, if the UK does soon achieve an agreed deal on Brexit, including some additional clarification wording on the Irish border backstop, then it is possible that growth could recover quickly. The MPC could then need to address the issue of whether to raise Bank Rate when there is very little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could falter and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by way of tax cuts and / or expenditure on infrastructure projects, to boost the economy. However, infrastructure projects generally take a long time to plan and to start up, and so to feed through into impacting the economy; tax cuts would be much quicker in impacting the level of consumption in the economy.

The first half of 2019/2020 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. This mirrored investor confidence around the world which is now expecting a significant downturn or possibly even a recession in some developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, (July 2.1%), and is likely to shift only a little upwards over the rest of 2019/2020. It does not therefore pose any immediate concern to the MPC at the current time.

With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.2% y/y), in quarter 2, employment rose by 115,000 in the same quarter: this suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment has continued near to a 44 year low, edging up from 3.8% to 3.9% on the Independent Labour Organisation measure in June; however, that was caused by a rise in the participation rate to an all-time high. Job vacancies fell for a sixth consecutive month, hitting record levels, and indicating that employers are having major difficulties filling job vacancies with suitable staff. It

was therefore unsurprising that wage inflation picked up to a high point of 3.9%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 1.8%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This could mean that the MPC will need to take action to raise Bank Rate if there is an agreed Brexit deal as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, if there is a general election soon, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. Financial markets are, however, expecting another cut in September. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

BOND YIELDS. It is this souring of investor confidence that has largely contributed to the sharp fall in bond yields on government debt in mid-2019 in the major western economies as investors have switched out of risky assets - equities, fearing an impending recession, and buying into bonds, so pushing their prices up and correspondingly, pushing yields down. Investors have little confidence that the US China trade war will have a satisfactory outcome in the near future and both sides look as if they are digging in to entrenched positions. However, most domestic US economic indicators are not currently pointing to a recession in the US, only to a slowing of growth. Provided the major world economies do avoid recession, then it is likely that there will be some reversal of this flow from equities into bonds and, therefore, that bond yields will recover to a limited extent from recent truly exceptional lows. However, the near-term reality is that we have seen 10 year bond yields fall below 2 year yields in the US; this has historically been a prime indicator of impending recession in the US, though this correlation has been much weaker in the UK. All German bond yields between 2 and 30 years are actually negative while many other EZ countries have bond yields which are also negative, at least in some maturity years.

EUROZONE. Growth has been slowing from +1.9% during 2018 to +0.4% q/q (+1.2% y/y) in quarter 1 and then to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 5.2% y/y in June with car production especially being hit. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars.

The ECB meeting in July expressed concern as to the weak outlook for growth and how low inflation was despite all the monetary stimulus the bank still has in place. The ECB is therefore expected to take action to cut its main rate of -0.4% further, but only marginally, and to look at the potential for more quantitative easing and/or other instruments of monetary policy to provide further stimulus to economic growth. On the political front, Spain and Italy are in the throes of trying to form coalition governments while the very recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. The trade war with the US does not appear to have had a significant effect on GDP growth as yet as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

JAPAN - has been struggling 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.

APPENDIX B

Interest rate forecast update (as prepared by Link Asset Services in the first week of September 2019)

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its last meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth.

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are currently a little below those to the downside.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU has had sharp disagreements in successive years with Italy over setting a budget within the limits of EU rules. (Early September – a new coalition government may be formed which would be less anti-EU.) The rating agencies have already downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance over €200bn of debt maturing in 2019. However, the biggest concern is the major holdings of Italian government debt held by Italian banks and insurers. Any downgrading of such debt would cause Italian bond prices to fall, causing losses on their portfolios, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices

etc. This is the so called **'doom loop'**. Due to the Italian government's already high level of debt, it would not be able to afford to bail out the banking system. **Portugal** faces the same problem as its debt is also only one notch above junk level.

- Weak capitalisation of some **European banks**, particularly Italian banks.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health. Early September 2019 – the results of the Saxony and Brandenburg regional elections were again very disappointing for the CDU and SPD; this will rejuvenate the tensions of October 2018 between these two parties that form the current coalition government.

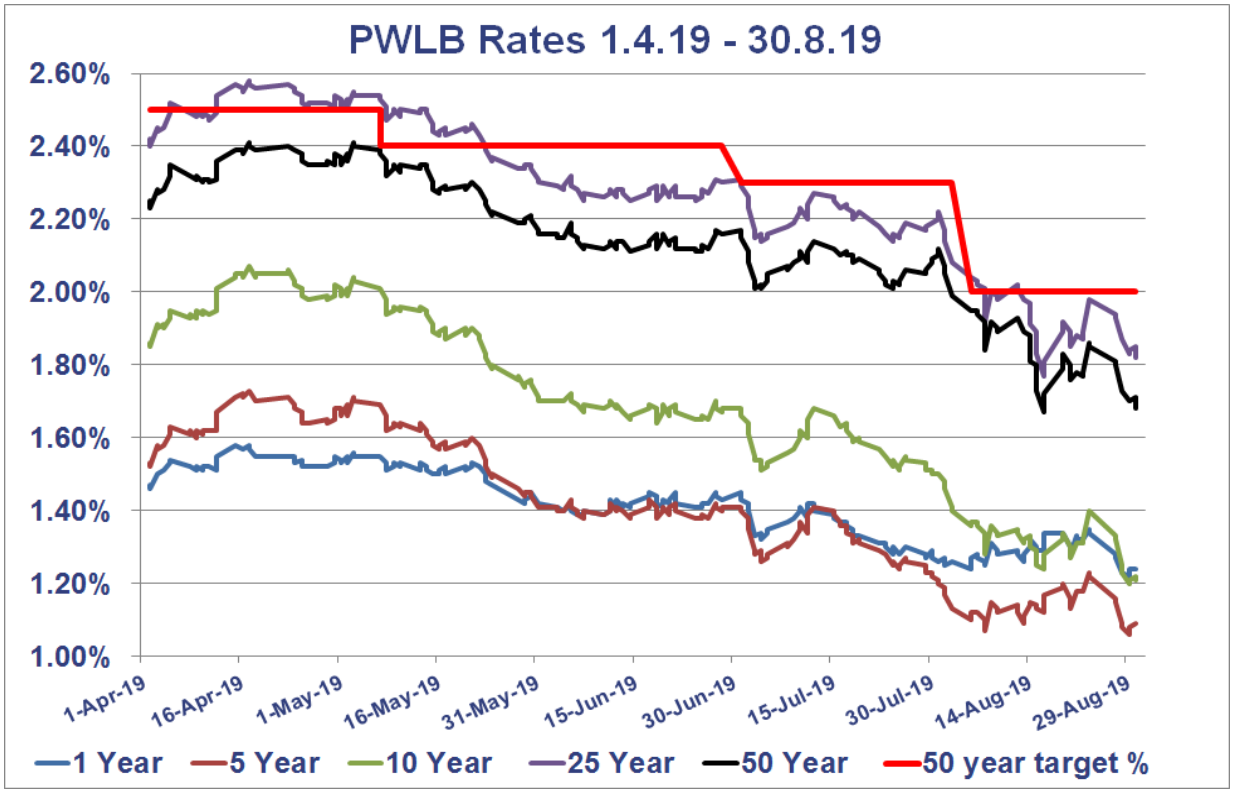
- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- The increases in interest rates in the US during 2018, combined with a trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. In mid-2019, investor fears of a looming recession have again sparked moves by investors out of riskier assets i.e. equities, into safe havens of government bonds of major western countries. Some **emerging market countries** which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields

APPENDIX C



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.22%	1.06%	1.20%	1.77%	1.67%
Date	29/08/2019	29/08/2019	29/08/2019	16/08/2019	16/08/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.41%	1.41%	1.68%	2.27%	2.13%