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South Cambridgeshire District Council

16 June 2020

To: Chair – Councillor Tony Mason
Vice-Chair – Councillor Nick Sample
Members of the Audit and Corporate Governance Committee – Councillors John Batchelor, Mark Howell, Dr. Ian Sollom, Heather Williams and Eileen Wilson

Quorum: 3

Substitutes: Councillors Nick Wright, Bunty Waters, Tom Bygott, Grenville Chamberlain, Graham Cone, Clare Delderfield and Dawn Percival

Dear Councillor

You are invited to attend the next meeting of **Audit and Corporate Governance Committee**, which will be held in **Virtual meeting - Online** at South Cambridgeshire Hall on **Tuesday, 24 November 2020** at **9.30 a.m.**

Members are respectfully reminded that when substituting on committees, subcommittees, and outside or joint bodies, Democratic Services must be advised of the substitution ***in advance of*** the meeting. It is not possible to accept a substitute once the meeting has started. Council Standing Order 4.3 refers.

Yours faithfully
Liz Watts
Chief Executive

The Council is committed to improving, for all members of the community, access to its agendas and minutes. We try to take all circumstances into account but, if you have any specific needs, please let us know, and we will do what we can to help you.

Agenda

Audit Reports

Information Items

The next scheduled meeting is 23 March 2021.

Guidance Notes for Members of the Public for Remote Meetings

Members of the public are welcome to view the live stream of this meeting, except during the consideration of exempt or confidential items, by following the link to be published on the Council's website.

Any person who participates in the meeting in accordance with the Council's procedure rules, is deemed to have consented to being recorded and to the use of those images (where participating via video conference) and/or sound recordings for webcast purposes. When speaking, members of the public should not disclose any personal information of any individual as this might infringe on the rights of that individual and breach the Data Protection Act.

For more information about this meeting please contact democratic.services@scambs.gov.uk

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South Cambridgeshire District Council

Minutes of a meeting of the Audit and Corporate Governance Committee held on Tuesday, 29 September 2020 at 9.30 a.m.

PRESENT: Councillor Tony Mason – Chair
Councillor Nick Sample – Vice-Chair

Councillors:	John Batchelor	Mark Howell
	Heather Williams	Eileen Wilson
Officers:	Patrick Adams	Senior Democratic Services Officer
	Peter Maddock	Head of Finance
Auditors:	Suresh Patel	Ernst & Young
	Jonathan Tully	Head of Shared Internal Audit

Councillor John Williams was in attendance, by invitation.

1. Apologies for Absence

Apologies for Absence were received from Councillor Ian Sollom.

2. Declarations of Interest

Councillor John Batchelor declared a non-pecuniary interest in item 5 Statement of Accounts, as an unpaid director of Ermine Street Housing. He took no part in the discussion on this item.

Councillor Mark Howell declared a non-pecuniary interest, as he and his wife were friends with an employee of EY, who was not involved in the auditing of the Council.

3. Minutes of Previous Meeting

The minutes of the meeting held on 9 July 2020 were agreed as a correct record.

4. Annual Governance Statement and Local Code of Governance

The Head of Internal Audit explained that the Annual Governance Statement needed to be agreed in advance of the Statement of Accounts. He also explained that the Annual Governance Statement needed to take into account the financial year 2018/19 up until the date the accounts were signed off, which was why the report included references to the impact of the Covid-19 pandemic. The Head of Internal Audit reported that there had been guidance from CIPFA on how to deal with the challenges of the Covid-19 pandemic, but the diverse nature of local authorities meant that Councils had to adapt to their own local circumstances.

In response to questioning, the Head of Internal Audit agreed to update the

Statement to refer to the fact the new Constitution had been agreed and amend the word “of” to “off” in the first line of the 5th bullet point under “Manage risk & performance, internal control, finance” on page 20 of the agenda.

It was agreed that the issue of page numbers not appearing on individual reports on the website would be investigated.

The Committee

Agreed To approve the Annual Governance Statement, with the minor amendments made above.

5. Statement of Accounts 2018/19

The Head of Finance introduced this report on the draft Statement of Accounts 2018/19. He explained that it had come to the Committee later than hoped, but it could not be finalised until the 2017/18 accounts had been audited. He further explained that the audit of the accounts would commence in October and was estimated to take two months.

Councillor Heather Williams agreed to submit a list of minor amendments to the Head of Finance.

Allowances
In response to questioning, the Head of Finance agreed to investigate why Members expenses for 2018/19 was £7,000 higher than 2017/18 when the number of councillors had reduced from 57 to 45.

Comprehensive Income statement
In response to questioning, the Head of Finance explained that the reduction in the Comprehensive Income statement was due to the reduction in the number of Council dwellings in the previous year.

Pension
The Head of Finance assured the Committee that whilst there was a shortfall in the Pension scheme, the scheme itself was not under threat. Suresh Patel added that the figures in the Statement of Accounts were over a year out of date and he was not aware of major concerns regarding the Pension scheme.

The Committee **Noted** the 2018/19 draft Statement of Accounts.

6. External Audit: Outline Audit Plan 2018/19

Suresh Patel, External Auditor, introduced this Outline Audit Plan, which set out the scope of the audit of the 2018/19 accounts.

Value for money
Suresh Patel explained that External Audit would make an informed decision on whether the Council had put in place “proper arrangements” to secure economy,

efficiency and effectiveness on its use of resources.

Audit fees
In response to questioning, both Suresh Patel and the Head of Finance assured the Committee that the external audit's fees had been reduced due to their capacity issues which had made them unable to be as efficient with their time as they had hoped. The Head of Finance added that the Council had also been similarly inefficient, which had also delayed the audit. Suresh Patel estimated that the fee had been reduced by approximately 15%.

Avoiding delays in processing the audit
Suresh Patel explained that he had a fully resourced audit team, but they were reliant on the officers from the Council. The Head of Finance explained that the Project Accountant would be leaving the Council in less than a month's time. His replacement would be in post before he left, allowing a two week handover period. It was noted that the new appointment's contract extended to the end of March 2021, he came well recommended and was experienced in the specific work required.

Suresh Patel explained that there would be weekly catch-up meetings between senior officers and auditors to investigate any slippage in the expected timescale.

New financial systems
In response to concerns expressed about the new Fixed Asset Register and FMS financial system, Suresh Patel explained that both systems were designed to improve financial reporting.

Impact of Covid-19
The Head of Finance explained that the Council supported officers who wished to work at home and provided them with equipment from the office. The accountancy service was carrying out more work online than before and officer support was available to scan documents if necessary. However, much of the accountancy work benefited from face to face meetings. This meant that due to the Covid-19 pandemic, work was taking a little longer than normal to complete. Suresh Patel concurred and said that remote working had slightly increased the time it took to carry out audits.

The Committee **Noted** the Plan.

7. Annual External Audit Letter for 2017/18

The Committee **Noted** the Annual Audit Letter, which concluded that the financial statements gave a true and fair view of the financial position of the Council as at 31 March 2018.

8. Treasury Management Annual Report 2019/20

The Head of Finance presented this report on the Treasury Management activities in the financial year 2019/20. He explained that there was a minor error in the table on page 217 of the agenda, where the figure for Net Borrowing (Investment) for 31

March 2020 was 103,404 not 111,719. He concluded that the returns were slightly higher than expected and were also slightly higher than the client average. He explained that the Council planned to borrow in short term, as it ensured lower rates that longer-term loans.

Committee **Noted** the Treasury Management performance and **Approved** the Treasury Management Annual Report.

9. Matters of Topical Interest

RIPA powers
The Committee noted that the Council had not used RIPA surveillance powers in the last quarter.

Redman Review on Financial Reporting
Suresh Patel agreed to share a short summary of the Local Authority review of financial reporting

Committee effectiveness toolkit
It was agreed that the above item should be on the agenda for the next meeting.

10. Date of Next Meeting

It was noted that the next meeting was scheduled for 24 November 2020 at 9:30am.

The Meeting ended at 11.15 a.m.

South Cambridgeshire District Council

REPORT TO:	Audit & Corporate Governance Committee	24 November 2020
LEAD CABINET MEMBER:	Not Applicable	
LEAD OFFICER:	Head of Shared Internal Audit	

Internal Audit update

Executive Summary

1. The purpose of this report is to inform the committee of the work of Internal Audit, completed between April 2020 to October 2020, the current opinion of Internal Audit, our forward plan of work, and operational developments.
2. The role of Internal Audit is to provide the Audit & Corporate Governance Committee, and Management, with independent assurance on the effectiveness of the internal control environment.

Recommendations

3. It is recommended that the Committee note the contents of the report.

Reasons for Recommendations

4. Regular reporting to the Audit & Corporate Governance Committee helps the Committee to understand the governance, risk and control environment, and contribute to the completion of the Annual Governance Statement.

Details

5. The Accounts and Audit Regulations 2015 require that the Council "must undertake an effective internal audit to evaluate the effectiveness of its risk management, control and governance processes; taking into account public sector internal auditing standards or guidance."
6. Internal Audit assists the Council, and the Audit & Corporate Governance Committee, to discharge its governance responsibilities. Our work supports the Council's corporate objectives, and the corporate governance framework.
7. Internal audit coverage is planned so that the focus is upon those areas and risks which will most impact upon the council's ability to achieve its objectives.
8. Internal Audit work should help add value to the Council by helping to improve systems, mitigate risks, and subsequently inform the Annual Governance Statement.

Options

9. There are no options to consider.

Implications

10. There are no significant implications arising.

Effect on Council Priority Areas

Growing local businesses and economies

11. Not applicable

Housing that is truly affordable for everyone to live in

12. Not applicable

Being green to our core

13. Not applicable

A modern and caring Council

14. The Internal Audit Plan is a key component in helping to provide assurance that the Council has a robust Governance, Risk and Control framework. The plan is cross-cutting, as it considers all Council activities, and also contributes to all Council Priorities.

Background Papers

Not applicable

Appendices

Appendix A: Progress Report

Appendix B: Glossary of terms

Report Author:

Jonathan Tully – Head of Shared Internal Audit

Telephone: (01223) 458180

Appendix A – Progress report

GREATER CAMBRIDGE
SHARED AUDIT

South Cambridgeshire District Council

Introduction

1. Management is responsible for the system of internal control and establishes policies and procedures to help ensure that the system is functioning correctly. On behalf of the Audit & Corporate Governance Committee, Internal Audit acts as an assurance function by providing an independent and objective opinion on the control environment.

2. The purpose of this report is to provide an update on the recent work completed by Internal Audit. The information included in the progress report will feed into and inform our overall opinion in the annual Head of Internal Audit (HoIA) report. This opinion will in turn be used to inform the Annual Governance Statement which accompanies the Statement of Accounts. We previously provided an update, to the committee, in March 2020.

3. Where appropriate, reports are given an overall opinion based on four levels of assurance. This is based on the evaluation of the control environment, and the type of recommendations we make in each report. If a review has either “Limited” or “No” assurance, the system is followed up to review if the actions were implemented promptly and effectively. Further information is available in Appendix B – Glossary of terms.

Resources and team update

Audit plan

4. An audit plan is presented at least annually to the Audit & Corporate Governance Committee. It is good practice to continually review the plan, to reflect emerging risks, revisions to corporate priorities, and changes to resourcing factors.

5. At the July 2020 meeting the Committee approved our current audit plan. We recognised that due to the Covid-19 pandemic, a six-month plan was the most appropriate approach, and that we would review this throughout the year. This

gave us the flexibility to respond to pandemic and deliver audit plan that added value to the Council.

6. As anticipated, we have been providing the Council with support on Business Grant stimulus packages. The amount of resource required for this activity has impacted our normal assurance work. However, we are pleased to have still completed audit reviews in the period as this will enable us to provide an opinion on the internal control environment.

7. Our plan is risk based, and in most cases any delayed reviews will commence at the next suitable opportunity. We have identified one new review to add to the plan, which is providing assurance on the Covid-19 Income Grants to Local Government. This work will need to be timed to support the statutory returns to Central Government.

8. Progress of the plan delivery, plus our forward plan, is illustrated on the following pages for information.

9. We have successfully appointed a Principal Internal Auditor to the team, which was recommended by our PSIAS inspection to support our long-term development of the team.

10. We started to use Teams and SharePoint software last year. This software enables us to hold virtual meetings and conference calling, plus co-author and display documents in real-time. We were keen to adopt this to reduce unnecessary travel between various sites. A further benefit is that we were relatively well prepared to adapt to homeworking during the pandemic, and can provide the Committee with assurance that we have been working effectively during this period.

Progress of the plan

Finalised reviews

The following audit and assurance reviews have reached completion, since the previous report to the committee:

Audit	Assurance and actions		Summary of report and actions
Carbon management - Data Quality	**Assurance:** Current: Previous: Organisational Impact: **Actions:** Critical High Medium Low	 Limited Limited Minor 0 2 4 0	The Council collected carbon emission data to report its second set of annual GHG emissions accounts, for the reporting period 1st April 2019 – 31st March 2020. They follow the principles of the latest Environmental Reporting Guidelines issued by the Departments for Environment, Farming and Rural Affairs, (DEFRA), and Business Energy and Industrial Strategy (BEIS). We reviewed information presented in the draft annual report, the spreadsheet calculations, and sample tested available supporting data for accuracy. As a result of this work, we are able to confirm that: • calculations and formulas have been accurately applied in the establishment of individual and total carbon emissions figures; • baseline data for 2018/2019 Footway Lighting should be restated due to changes in the collected data; • source data was verified for the majority of datasets, however there is scope for further improvement by using actual consumption data, rather than estimated or suppliers projected consumption figures in respect of some datasets. This would enable us to provide a greater level of assurance. Overall, the reporting and calculation process is robust. As part of the review process we have also shared advice and tips on data collection, management and presentation where we identified opportunities for improvement.

Audit	Assurance and actions		Summary of report and actions
Grant assurance - Disabled Facility Grant 	**Assurance:** Current: Previous: Organisational Impact: **Actions:** Critical High Medium Low	 Reasonable Limited Minor 0 0 2 0	Central Government funding is allocated to the County Councils as part of the Better Care Fund. A proportion of this is allocated to District Councils to enable them to carry out improvements to housing stock, and for disabled adaptations. We reviewed a sample of grants from the financial year, plus their supporting documentation and transactions. This provided assurance that: • grant applications were legitimate, and only awarded to eligible applicants; • applications were supported by a qualified and independent medical referral; • applications were processed promptly; • suppliers and contractors were appropriately procured, and awarded based on value for money; • any project cost variations were appropriately reviewed and approved; • financial records were completed and reconciled; • projects were effectively managed by the Home Improvement Agency; and • grants were used for capital expenditure as set out in the MHCLG conditions. Our testing identified an immaterial reconciliation error, and some HIA fees from the period which still needed to be invoiced. These are easily rectified, and the team has agreed two actions that will help improve their internal processes.

Audit	Assurance and actions		Summary of report and actions
Program assurance - ISO14001 - Visit 1	**Assurance:** Current: Previous: **Actions:** Critical High Medium Low	 Reasonable Reasonable 0 0 0 2	We completed a Program Assurance review to support the periodic BSI inspection, which covered: • context of the organisation – internal and external factors; • aspects and impacts; • objectives and targets, monitoring and measuring; • training, competence and awareness; • control of documented information; • operational control and change management; and • nonconformity, correction and corrective action The team had implemented previous actions; and there were no significant non-conformities arising. We highlighted that the version control of the teams Integrated Management System could be updated to evidence the latest changes.

Audit	Assurance and actions		Summary of report and actions
Program assurance - ISO9001 - Visit 1	**Assurance:** Current: Previous: **Actions:** Critical High Medium Low	 Reasonable Reasonable 0 0 0 1	We completed a Program Assurance review to support the periodic BSI inspection, which considered: • Quality Management System; • Customer related processes, Contracts, Specifications and KPIs; • Purchasing, Subcontractors, Supplier Evaluation, Stores and Materials; and • Resources: Competence Training and Awareness. The team had implemented previous actions; and there were no significant non-conformities arising. We highlighted that the version control of the teams Integrated Management System could be updated to evidence the latest changes.

Audit Opinion

11. The audit plan enables me to provide an independent opinion on the adequacy and effectiveness of the systems of internal control in place (comprising risk management, corporate governance and financial control). This opinion will inform the Annual Governance Statement.

12. Our work is carried out to assist in improving control. Management maintains responsibility for developing and maintaining an internal control framework. This framework is designed to ensure that:

- the Council's resources are utilised efficiently and effectively;
- risks to meeting service objectives are identified and properly managed; and
- corporate policies, rules and procedures are adequate, effective and are being complied with.

13. Assurance is received from a number of sources. These include the work of Internal Audit; assurance from the work of the External Auditor; the Annual Governance Statement together with the Local Code of Corporate Governance and the Risk Management process. This enables a broader coverage of risks and ensures that the totality of the audit, inspection and control functions deployed across the organisation are properly considered in arriving at the overall opinion.

14. If the audit reviews undertaken identified that the control environment was not strong enough, or was not complied with sufficiently to prevent risks to the organisation, Internal Audit has issued recommendations to further improve the system of control and compliance. Where these recommendations are considered to have significant impact on the system of internal control, the implementation of actions is followed-up by Internal Audit.

15. It is the opinion of the Head of Shared Internal Audit that, taking into account all available evidence, reasonable assurance may be awarded over the adequacy and effectiveness of the Council's overall internal control environment, governance and risk management arrangements. The Council has had to adapt to the Coronavirus pandemic and has maintained internal controls effectively in this period. The level of assurance remains at a similar level to the previous year.

Our work in progress and forward plan

Below is a table of our forward plan for the next six months. Some reviews are in progress, and we have also provided an update on their status:

Audit	Assurance type	Progress update	Scope and description
A modern and caring Council			
Corporate Complaints and Feedback	Compliance	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	Review of the complaints process to provide assurance that it is effective in helping the Council to continuously improve its services
Procure to Pay	Compliance	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	Desktop review of the procurement system and new processes. A sample of transactions will be reviewed to ensure they are promptly and appropriately authorised.
Information Governance - GDPR	Compliance	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	Compliance check on a selection of thematic areas and participation in corporate information governance program.
Growing local businesses and economies			
Program assurance - ISO14001 - Visit 2	Compliance	This review is planned for the second half of 2020/2021.	Allocation of resource to provide independent assurance for the continuous ISO program for environmental standards
Program assurance - ISO9001 - Visit 2	Compliance	This review is planned for the second half of 2020/2021.	Allocation of resource to provide independent assurance for the continuous ISO program for quality standards

Audit	Assurance type	Progress update	Scope and description
Planning Fee Income	Risk based	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	Review of system for managing planning fee income. Ensuring that policies are in place for both discretionary and nationally set charging, and that income opportunities are maximised, debts collected, and balances reconciled to main accounting systems.
Housing that is affordable for everyone to live in			
HRA - Electrical Safety Compliance - Follow-up	Follow-up	This review is currently in progress	Follow-up review to ensure that actions have been implemented successfully.
HRA - Gas Safety Compliance - Follow-up	Follow-up	This review is currently in progress	Follow-up review to ensure that actions have been implemented successfully.
Core Assurance Work			
Payroll	Key Financial System	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	An annual key controls audit as part of cyclical review of core systems.
Accounts Receivable	Key Financial System	This was approved in our original plan. It is now scheduled for the second half of 2020/2021.	Follow up review to ensure actions from our previous review were implemented effectively.

Audit	Assurance type	Progress update	Scope and description
Covid19 - Central Govt Income Relief Grants	Grant assurance	This is a new review which has been added to the plan.	To provide assurance that grant allocation from Central Government has been calculated correctly, to minimise grant claw back.

Other audit and assurance activity

National Fraud Initiative

16. The Council participates in a national data matching service known as the National Fraud Initiative (NFI), which is run by the Cabinet Office. Data is extracted from Council systems for processing and matching. It flags up inconsistencies in data that may indicate fraud and error, helping councils to complete proactive investigation. Nationally it is estimated that this work has identified £1.69 billion of local authority fraud, errors and overpayments since 1996. Historically this process has not identified significant fraud and error at South Cambridgeshire District Council, and this provides assurance that internal controls continue to operate effectively.

17. We have started preparing for the 2020/2021 exercise. This includes extracting, checking and processing data from Council systems; plus reviewing compliance with data protection regulations. Relevant datasets include: Trade Creditors; Council Tax and reductions; Payroll; Licenses – Taxi drivers; Housing; Electoral Register; and Business Grant recipients. At this stage we have already processed 17,619 records.

Business Grants

18. The team has been assisting the Council with delivery of Central Government funded Business Grant schemes. This work has included undertaking fraud and error risk assessments, so that we can proactively advise on the design of low friction controls. The schemes include funding to Retail Hospitality and Leisure, Small Business Grants and also our Local Discretionary Grant Scheme.

19. To help safeguard the public purse and ensure that funds are provided to legitimate applicants, we have developed a post-assurance plan, which sets out checks and tests. This involves various tests across the 2,189 grant payments made to date. We are utilising government recommended tools to check applicants for compliance with scheme eligibility. In addition, we have also designed our own local assurance tools, and this has helped us to proactively prevent some applications that were non-compliant with the regulations.

20. The work helps the Council to have assurance that it has taken proportionate and effective controls to mitigate the risk of fraud and error.

21. We are expecting to undertake similar work for the next round of grants from Central Government, for the National Lockdown scheme.

Public Sector Internal Audit Standards

22. The Public Sector Internal Audit Standards (PSIAS) require that Internal Audit develops and maintains a quality assurance and improvement programme that covers all aspects of the Internal Audit activity. External assessments must be conducted at least once every five years by a qualified, independent assessor. In 2018 CIPFA independently verified that we “Generally Conform” with the Public Sector Internal Audit Standards (PSIAS) and the accompanying Local Government Application Note (LGAN).

23. We completed our annual internal review which provides assurance that we continue to meet the standards. In addition, we have been responding to guidance issued by our professional bodies, and undertaking pandemic related risk assessments to help maintain compliance with the standards.

Governance

24. We facilitated the review of the Annual Governance Statement, and the Local Code of Governance, which accompanies the Statement of Accounts.

Appendix B – Glossary of terms

Assurance ratings

Internal Audit provides management and Members with a statement of assurance on each area audited. This is also used by the Head of Shared Internal Audit to form an overall opinion on the control environment operating across the Council, including risk management, control and governance, and this informs the Annual Governance Statement (AGS).

Term	Description
Full Assurance	Controls are in place to ensure the achievement of service objectives and good corporate governance, and to protect the Authority against significant foreseeable risks.
Reasonable Assurance	Controls exist to enable the achievement of service objectives and good corporate governance, and mitigate against significant foreseeable risks. However, occasional instances of failure to comply with control process were identified and/or opportunities still exist to mitigate further against potential risks.
Limited Assurance	Controls are in place and to varying degrees are complied with, however, there are gaps in the process which leave the service exposed to risks. Therefore, there is a need to introduce additional controls and/or improve compliance with existing ones, to reduce the risk exposure for the Authority.
No Assurance	Controls are considered to be insufficient, with the absence of at least one critical control mechanism. There is also a need to improve compliance with existing controls, and errors and omissions have been detected. Failure to improve controls leaves the Authority exposed to significant risk, which could lead to major financial loss, embarrassment, or failure to achieve key service objectives.

Organisational impact

The overall impact may be reported to help provide some context to the level of residual risk. For example if no controls have been implemented in a system it would have no assurance, but this may be immaterial to the organisation. Equally a system may be operating effectively and have full assurance, but if a risk materialised it may have a major impact to the organisation.

Term	Description
Major	The risks associated with the system are significant. If the risk materialises it would have a major impact upon the organisation.
Moderate	The risks associated with the system are medium. If the risk materialises it would have a moderate impact upon the organisation.
Minor	The risks associated with the system are low. If the risks materialises it would have a minor impact on the organisation.

Actions

As part of our reviews we identify opportunities for improvement, which have been shared with Management. These are developed into actions to improve the effectiveness of the governance, risk management arrangements, and the internal control environment.

Management are responsible for implementing their actions and providing assurance when they are completed. Timescales for implementing actions should be proportionate and achievable to the available resources. To help prioritise the actions we have produced guidance below:

Priority	Description	Timescale for action	Monitoring
Critical	Extreme control weakness that jeopardises the complete operation of the service.	To be implemented immediately.	Within 1 month
High	Fundamental control weakness which significantly increases the risk / scope for error, fraud, or loss of efficiency.	To be implemented as a matter of priority.	Within 6 months
Medium	Significant control weakness which reduces the effectiveness of procedures designed to protect assets and revenue of the Authority.	To be implemented at the first opportunity.	Within 12 months
Low	Control weakness, which, if corrected, will enhance control procedures that are already relatively robust.	To be implemented as soon as reasonably practical.	Within 24 months

The Council has a Risk Management system, which is used for tracking their progress.

South Cambridgeshire District Council

REPORT TO:	Audit & Governance	24 November 2020
LEAD CABINET MEMBER:	Councillor John Williams, Lead Cabinet Member for Finance	
LEAD OFFICER:	Peter Maddock, Head of Finance	

Mid Year 2020/2021 Treasury Management Report

Executive Summary

1. This report outlines the mid-year treasury management report to 30 September 2020, including performance against the approved Prudential Indicators for Treasury Management.

Key Decision

2. This is not a key decision as there are no resource implications directly arising from the report at this stage.

Recommendation

3. **That Committee is invited to review the Treasury Management activity and performance for the period to 30 September 2020.**

Reason for Recommendation

4. To review the Treasury Management activity and performance for the period 1 April 2020 to 30 September 2020.

Details

Treasury Management Strategy

5. The Council's Treasury Management Strategy and prudential indicators for 2020/2021 were approved by Full Council on 20 February 2020.

6. As part of the Council's Mid-Year Review, the Treasury Management Policy Statement and Treasury Management Strategy for 2020/2021 have been reviewed with regard to their compliance to the CIPFA Prudential Code and the CIPFA Treasury Management Code. They have also been reviewed to ensure their appropriateness in light of the Council's current investment and borrowing portfolios, and the ongoing delivery of the Council service objectives.

7. The economic landscape has changed immensely in the last 12 months, initially as a result of the uncertainty over the withdrawal process from the European Union, and recently the financial challenges as a result of the Coronavirus pandemic (COVID-19) which has had an impact on the Council's planned income and expenditure.

8. In addition, in March 2020, HM Treasury commenced a review of potential changes to the rules around local authorities borrowing from the Public Works Loans Board (PWLB). The main purpose of the proposed changes is to find a way of restricting the ability of local authorities to borrow for pure investment in commercial property and, in this regard, it has been suggested that, if local authorities acquired commercial assets primarily for yield, a borrowing restriction would mean that any such local authorities would not be able to take out new loans from the PWLB in that financial year – whether or not for commercial property acquisition.

9. The outcome of this review has yet to be published and, at this point in time, there is uncertainty over any potential changes to the borrowing rules and thus how the changes will impact on and need to be reflected within the Treasury Management Strategy (and the Council's Capital and Investment Strategies).

10. It is intended, therefore, that a full review of the Treasury Management Policy and Treasury Management Strategy Statement will be presented to Cabinet and Council as part of the 2021/2022 budget determination process.

11. The Council, as a consequence of its activities, has borrowed and invested substantial sums of money and is, therefore, exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk is therefore central to the Council’s treasury management strategy This report covers the treasury management activity for the period 1 April 2020 to 30 September 2020 and the associated monitoring and risk management.

12. Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Ministry for Housing, Communities & Local Government (MHCLG) published its revised investment Guidance which came into effect from April 2018.

13. The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be an overarching document approved by Full Council. The Council’s Capital Strategy was considered and approved by Full Council on 20 February 2020 and is being reviewed as part of the 2021/2022 budget process.

Investment Activity

14. As at 30 September 2020, the Council held £96.1 million of invested funds (nominal basis), representing income received in advance of expenditure plus balances and reserves held. The Council’s investment balances during 2020/2021 have averaged £102.7 million over the year.

15. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council’s aim is to achieve a yield consistent with these principles.

16. The portfolio has been managed throughout 2020 on the basis that there would be an external borrowing requirement for capital expenditure. In the period to 30 September 2020 further loans of £4.2 million have made to Ermine Street Housing and two commercial properties acquired at a cost of £19 million. This has been covered by current cashflows. Short term borrowing forecast has started in November 2020. This has allowed the Council to increase its allocation to higher yielding Ermine Street Housing loans. The remainder of the portfolio has been held in short term liquid money market funds and fixed deposits with other Local Authorities, Banks, Building Societies and a Housing Association.

17. The table below shows the opening balances of investments held at the beginning of the financial year and the movements on each fund up to 30 September 2020:

Investment Counterparty	01 April 2020	New	Matured	30 Sept 2020
Short Term:	**£000**	**£000**	**£000**	**£000**
Banks – Call/Liquidity Accounts	Nil	66,230	(66,230)	Nil
AAA Rated Money Market Fund	9,860	64,450	(71,880)	2,430
Clearing Banks	5,000	2,000	(5,000)	2,000
Other Banks	Nil	15,000	(13,000)	2,000
UK Local Authorities	9,500	30,130	(33,130)	6,500
Building Societies	Nil	20,500	(20,500)	Nil
Housing Associations	5,000	5,000	(5,000)	5,000
Total Short Term Investments	**29,360**	**203,310**	**(214,740)**	**17,930**

Investment Counterparty	01 April 2020	New	Matured	30 Sept 2020
Long Term:	**£000**	**£000**	**£000**	**£000**
South Cambs Ltd	71,644	4,165		75,809
Cambridge Leisure and Ice	2,400			2,400
Total Long Term Investments	**74,044**	**4,165**		**78,209**

Total Investments	**103,404**			**96,139**

18. The downward movement in value of £7.3 million is due to the reasons reflected in paragraph 16 above.

19. The most significant movements in the portfolio are a reduction of £7.4 million placed with Money Market Funds and a further £4.2 million loaned to Ermine Street Housing. A more detailed analysis of the investment portfolio as at 30 September 2020 is shown at **Appendix A**

20. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving low investment income.

21. In order to achieve these objectives, the Council's portfolio is diversified. The majority of the portfolio is invested in fixed deposits where Financial Institutions return 0.50% and Ermine Street Housing returns 3.71%. Liquidity assets typically return 0.09%. This has to 30 September 2020 generated the Council a blended return of 3.09%.

22. This has been achieved whilst maintaining a low level of credit risk. Counterparty credit quality is assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is [A-] across all major agencies); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. This is shown below.

	Weighted Average Risk Number	Investment Portfolio	Bail-In Exposure		Average Balance	Rate of Return
		£000	£000	%		
30 September 2020	3.45	96,139	11,000	11.4	14,000	0.50%
31 March 2020	2.53	103,404	10,000	9.7	21,000	0.91%

23. The table also shows how the Council's exposure to Bail in Risk has not significantly changed.

Borrowing Strategy

24. As at 30 September 2020, the Council held £205.123 million of long term debt (principal borrowed, excluding lease liabilities), no change on 31 March 2020. The Council held no short term debt at 30 September 2020.

25. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained low and are likely to remain at these levels over the forthcoming two years, the Authority has determined it is more cost effective in the short-term to use internal resources instead of external borrowing.

26. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Link Asset Services (Treasury Management Advisers) assist the Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity

27. At 31 March 2020 the Council had short term local authority borrowing of £10 million in addition to £205.123 million of PWLB loans for HRA self-financing. The table below sets out the movement in the Council's borrowing over the year to date. The Capital Financing Requirement (CFR) is unchanged in the six month period to 30 September 2020.

	01/04/2020	**Maturing Debt**	**Interest Paid**	**Lease Payments**	**CFR Movement**	**30/09/2020**
	£000	**£000**	**%**	**£000**		**£000**
CFR	309,030				0	309,030
Short Term Borrowing (a)	10,000	10,000	0.82	0		0
Long Term Borrowing (b)	205,123	0	3.51	0		205,123
Total Borrowing (a+b)	**215,123**	**10,000**		**0**		**205,123**
Other Long Term Liabilities (c)	0	0	0	0		0
Total External Debt (a+b+c)	**215,123**	**10,000**	**0.82**	**0**		**205,123**

PWLB Certainty Rate and Project Rate Update

28. Authorities are required to notify MHCLG of any potential future borrowing in order to obtain 'Certainty Rate' (0.20% below the PWLB standard rate) the Council has submitted an application to borrow at this rate until November 2020. There is no penalty if the facility is not used.

Debt Rescheduling

29. The premium charge for early repayment of PWLB debt has become very expensive for the loans in the Council's portfolio and, therefore, unattractive for debt rescheduling activity. As a consequence, no rescheduling activity has been undertaken.

2020/2021 Budget Monitoring

30. The Finance Team monitor and report on the Capital Financing budget on a regular basis. The latest position as at 30 September 2020 is shown in the table below:

	Current Budget	**Forecast Outturn**	**Forecast Variance**
	£000	**£000**	**£000**
Interest Payments	1,451	65	(1,386)
Minimum Revenue Provision	1,398	870	(528)
Total Expenditure	**2,849**	**935**	**(1,914)**
Investment Income	(3,232)	(3,027)	205
Commercial Property Rental Income	(1,305)	(1,510)	(205)
Total Income	**(4,537)**	**(4,537)**	**0**
Net Budget	**(1,688)**	**(3,602)**	**(1,914)**

31. Interest Payments are forecast to be lower than originally budgeted as the expectation of long term borrowing during the year will not be required, due to higher investment balances and use of short term borrowing in the near term.

32. Minimum Revenue Provision shows a saving of £0.528 million due. This saving occurred because the acquisition of Peterborough Business Park did not proceed and commercial investment in 296 Cambridge Science Park will be funded from the General Fund balance.

33. Investment Income is forecast to come in on budget. Although rates with Banks and Money Market funds are at historic lows, this has been balanced by greater commercial rent income. The early acquisition of Commercial Property in the financial year will off-set the reduced interest achieved on lending to Counterparties. Interest rates are much lower than forecast due to reductions in Base Rate as a result if the Coronavirus Pandemic. The first national lockdown also led to a slippage on the Ermine Street Housing acquisition programme. Ermine Street Housing continues to make a significant contribution, with a slightly lower forecast outturn of £2.779 million versus original forecast of £3.015 million.

External Economic Impact on Portfolio

34. The external economic context and market rate data is referenced in the Treasury Advisers report reproduced at **Appendix B.**

35. In response to the emerging crisis interest rates were cut globally with banks seeking to provide liquidity through the purchase of financial assets. In the UK itself, the Bank of England cut the Base Rate initially on 11 March 2020 to 0.25% (from 0.75%) and subsequently it was reduced further on 19 March 2020 to a record low level of 0.1%. This consequently decreased the return on the Council's Money Market Fund holdings and gives a reduced return on maturing deposits when reinvested.

Compliance with Performance Indicators

36. The Council has been compliant with the 2020/2021 Prudential Indicators approved by Full Council on 20 February 2020 except where indicated. All exceptions are due to the high levels of investments held in short term money market funds and overnight bank accounts.

37. The Council measures and manages its exposures to treasury management risks using the following indicators:

38. Performance against prudential indicators in 2020/2021 is as follows:

(1) Interest Rate Exposure: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures are set out in the table below:

Maturity structure of borrowing	Under 12 months	More than 12 months	Under 12 months - Actual	More than 12 months - Actual
Upper limit for fixed interest rate exposure	100%	100%	0%	100%
Upper limit for variable rate exposure	100%	0%	0%	0%

(2) Maturity Structure of Borrowing: The structure of the Council's borrowing is set out below.

Fixed Rate Borrowing		
Lender	Repayable within	Amount £,000
Local Authorities	<12 Months	0
PWLB	15 – 20 years	45,000
PWLB	20 – 25 years	50,000
PWLB	25 – 30 years	50,000
PWLB	30 – 35 years	50,000
PWLB	35 – 40 years	10,123

(3) Principal Sums Invested for Periods Longer than 364 Days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The Council takes in consideration the advice of its Treasury Advisers when determining the duration of investments with financial institutions (excluding Ermine Street Housing and Cambridge Leisure and Ice Centre) The suggested duration for our counterparties are:

Counterparty	Suggested maximum duration	Actual duration	Total investments £000
Local Authorities	5 years	183 days	6,500
Close Brothers	6 months	189 days	2,000
Places for People[1]	N/A	364 days	5,000
Lloyds	6 months	32 days notice	2,000

[1] Not assessed by the Council's appointed Treasury Advisers

(4) Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by maintaining a minimum £20 million working cash balance (total investment balance less loans to Ermine Street Housing and Cambridge Leisure & Ice). This liquidity is available to meet unexpected payments without additional borrowing.

Counterparty Type	Amount £000	% of Portfolio at 30 September
Long term (>1yr)		
Ermine St Housing	75,809	79
CLIC	2,400	3
Total Long term	**78,209**	**82**
Short term (<365 days)		
Banks	4,000	2
Building Societies	0	0
Housing Assoc.	5,000	5
Local Authorities	6,500	7
Money Market Funds	2,430	3
Short Term (Working Cash Balance)	**17,930**	**14**

Outlook for Quarter 4 2020/2021

39. The Council will continue to make acquisitions under the Investment Strategy and make further loans to Ermine Street Housing. The Council will receive minimal receipts from Council Tax and National Non Domestic Rates during February and March 2020 and it is forecast that £39 million in short term loans will be required to manage cash flow needs.

40. The view is that the UK economy still faces a challenging outlook as the Government continues to negotiate the country's exit from the European Union and responds to the economic conditions caused by COVID-19.

Implications

41. In the writing of this report, taking into account the financial, legal, staffing, risk management, equality and diversity, climate change, community safety and any other key issues, the following implications have been considered:

Legal

42. It is a statutory duty, under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to approve a range of prudential indicators as part of its approval of the General Fund Revenue Budget and Capital Programme.

43. The Chartered Institute of Public Finance and Accountancy’s Treasury Management Code (CIPFA’s TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

Policy

44. There are no specific policy implications associated with the recommendations contained in this report. The Chartered Institute of Public Finance & Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (the CIPFA Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities 2017 (as amended) have been used in the preparation of this report.

Finance

45. There are no new resource implications associated with the recommendations contained in this report.

Risks

46. There are no specific risk implications associated with the recommendations contained in this report.

Environmental

47. There are no specific environmental implications associated with the recommendations contained in this report.

Equality and Diversity

48. In preparing this report, due consideration has been given to the Council's statutory Equality Duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relations, as set out in Section 149(1) of the Equality Act 2010.

49. A relevance test for equality has determined that the activity has no relevance to South Cambridgeshire District Council's statutory equality duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relation. An equality impact assessment is not needed.

Effect on Council Priority Areas

50. Timely and robust consideration of the Council's treasury management activities is vital to ensure that financial performance is in line with expectations.

Background Papers

Where the Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012 require documents to be open to inspection by members of the public, they must be available for inspection:

(a) at all reasonable hours at the offices of South Cambridgeshire District Council;

(b) on the Council's website; and

(c) in the case of documents to be available for inspection pursuant to regulation 15, on payment of a reasonable fee required by the Council by the person seeking to inspect the documents at the offices of South Cambridgeshire District Council.

The following documents are relevant to this report:

- General Fund Medium Term Financial Strategy – Report to Cabinet: 4 December 2019
- General Fund Budget Report – Report to Cabinet: 5 February 2020
- General Fund Budget – Report to Council: 20 February 2020

Appendices

A Schedule of Investments as at 30 September 2020

B Treasury Management Adviser – External Economic Context and Market Rate Data

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Appendix A – Schedule of Investments as at 30 September 2020

	Amount	Interest	Total	Term	Rate	Maturity Date
	£000	£000	£000	Days	%	
Counterparty						
Aberdeen Std Life MMF	2,430		2,430	Overnight	0.08	01/10/2020
Lloyds 32d Notice ac	2,000		2,000	32	0.10	10/11/2020
Places for People	1,000	14.959	1,015	364	1.50	26/05/2021
Cheltenham BC	2,000	5.014	1,005	183	0.50	20/11/2020
Places for People	2,500	10.712	2,510	183	0.85	31/12/2020
Places for People	1,500	22.438	1,522	364	1.50	05/07/2021
Close Brothers	1,000	2.379	1,002	193	0.45	22/03/2021
Close Brothers	1,000	2.281	1,002	185	0.45	22/03/2021
LB of Bexley	4,500	0.022	4,500	1	0.18	01/10/2020
Ermine Street Housing	71,957				3.85	Various
Ermine Street Housing	3,852				1.00	Various
Cambridge Leisure & Ice	2,400			25 Years	4.31	31/03/2043
Total	96,139					

Appendix B – Treasury Management Adviser – External Economic Context and Market Rate Data

Economics update

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interest Rate Forecasts 2020 - 2023

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

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

Additional notes by Link on this forecast table:

- Please note that Link have made a slight change to our interest rate forecasts table above for forecasts for 3, 6 and 12 months. Traditionally, Link have used LIBID forecasts, with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that all LIBOR rates up to 6 months are currently running below 0.1%, using that convention would give negative figures as forecasts for those periods. However, the liquidity premium that is still in evidence at the short end of the curve, means that the rates actually being achieved by local authority investors are still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 0.05% is achievable for 3 months, 0.1% for 6 months and 0.15% for 12 months.

- During 2021, Link will be continuing to look at market developments in this area and will monitor these with a view to communicating with clients when full financial market agreement is reached on how to replace LIBOR. This is likely to be an iteration of the overnight SONIA rate and the use of compounded rates and Overnight Index Swap (OIS) rates for forecasting purposes.

- If clients require forecasts for 3 months to 12 months beyond the end of 2021, a temporary fix would be to assume no change in our current forecasts. Link will maintain continuity by providing clients with LIBID investment benchmark rates on the current basis.

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

Gilt Yields / PWLB Rates. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the Coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

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

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

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

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

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

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the Coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

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

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

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

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

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