

Treasury Management Mid-Year Performance Report 2021 / 22

Introduction

In February 2011 the council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2021/22 was approved at a meeting of Isle of Wight Council's Audit Committee on 15 March 2021. The council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the council's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 24 February 2021.

External Context (Provided by Arlingclose Limited, based on data at 8 October 2021)

Economic background: The economic recovery from coronavirus pandemic continued to dominate the first half of the financial year. By the end of the period over 48 million people in the UK had received their first dose of a COVID-19 vaccine and almost 45 million their second dose.

The Bank of England (BoE) held the Bank Rate at 0.1 percent throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. In its September 2021 policy announcement, the BoE noted it now expected the UK economy to grow at a slower pace than was predicted in August, as the pace of the global recovery had shown signs of slowing and there were concerns inflationary pressures may be more persistent. Within the announcement, Bank expectations for GDP growth for the third (calendar) quarter were revised down to 2.1 percent (from 2.9 percent), in part reflecting tighter supply conditions. The path of CPI inflation is now expected to rise slightly above 4 percent in the last three months of 2021, due to higher energy prices and core goods inflation. While the Monetary Policy Committee meeting ended with policy rates unchanged, the tone was more hawkish.

Government initiatives continued to support the economy over the quarter but came to an end on 30 September 2021, with businesses required to either take back the 1.6 million workers on the furlough scheme or make them redundant.

The latest labour market data showed that in the three months to July 2021 the unemployment rate fell to 4.6 percent. The employment rate increased, and economic activity rates decreased, suggesting an improving labour market picture. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 8.3 percent and 6.3 percent respectively over the period. However, part of the robust growth figures is due to a base effect from a decline in average pay in the spring of last year associated with the furlough scheme.

Annual CPI inflation rose to 3.2 percent in August, exceeding expectations for 2.9 percent, with the largest upward contribution coming from restaurants and hotels. The Bank of England now expects inflation to exceed 4 percent by the end of the calendar year owing largely to developments in energy and goods prices. The Office of National Statistics' (ONS') preferred measure of CPIH which includes owner-occupied housing was 3.0 percent year/year, marginally higher than expectations for 2.7 percent.

The easing of restrictions boosted activity in the second quarter of calendar year, helping push GDP up by 5.5 percent q/q (final estimate vs 4.8 percent q/q initial estimate). Household consumption was the largest contributor. Within the sector breakdown production contributed 1.0 percent q/q, construction 3.8 percent q/q and services 6.5 percent q/q, taking all these close to their pre-pandemic levels.

The US economy grew by 6.3 percent in Q1 2021 (Jan-Mar) and then by an even stronger 6.6 percent in Q2 as the recovery continued. The Federal Reserve maintained its main interest rate at between 0 percent and 0.25 percent over the period but in its most recent meeting made suggestion that monetary policy may start to be tightened soon.

The European Central Bank maintained its base rate at 0 percent, deposit rate at -0.5 percent, and asset purchase scheme at €1.85 trillion.

Financial markets: Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, than was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a dearth of HGV lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, lead to higher prices.

The 5-year UK benchmark gilt yield began the financial year at 0.36 percent before declining to 0.33 percent by the end of June 2021 and then climbing to 0.64 percent on 30 September. Over the same period the 10-year gilt yield fell from 0.80 percent to 0.71 percent before rising to 1.03 percent and the 20-year yield declined from 1.31 percent to 1.21 percent and then increased to 1.37 percent.

The Sterling Overnight Rate (SONIA) averaged 0.05 percent over the quarter.

Credit review: Credit default swap spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In late September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but are now falling back. The gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow, but Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 53 basis points (bps) and Lloyds Banks Plc the lowest at 32bps. The other ringfenced banks were trading between 37-39bps and Nationwide Building Society was 39bps.

Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

Fitch also revised the outlooks for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable from negative. The rating agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.

At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits. The outcome of this review included the addition of NatWest Markets plc to the counterparty list together with the removal of the suspension of Handelsbanken plc. In addition, the maximum duration for all recommended counterparties was extended to 100 days.

As ever, the institutions and durations on the council's counterparty list recommended by treasury management advisors Arlingclose remain under constant review.

Local Context

On 31 March 2021, the council had net borrowing of £174.4 million arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.03.21 Actual £m
Total CFR	409.0
Less: Other debt liabilities*	(100.0)
Borrowing CFR	309.0
External borrowing **	(242.7)
Internal / (over) borrowing	66.3
Less: Usable reserves	(128.1)
Less: Working capital	(6.5)
(Investments) / New Borrowing	(68.3)

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt

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

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The council

pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

The treasury management position on 30 September 2021 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.21 Balance £m	Movement £m	30.09.21 Balance £m	30.09.21 Rate percent
Long-term borrowing	197.7	(6.4)	191.3	3.15%
Short-term borrowing	45.0	(10.0)	35.0	0.15%
Total borrowing	242.7	(16.4)	226.3	2.78%
Short-term investments	68.3	10.6	78.9	0.06%
Total investments	68.3	10.6	78.9	0.06%
Net borrowing	174.4	(27.0)	147.4	4.24%

Short-term borrowing reduced during the first half of the year as, the council has continued to use the cash reserves to repay the existing short term borrowing. There have also been sufficient funds to advance further funds to other local authorities thereby reducing the cost of carry that has been incurred during the period.

Borrowing Update

PWLB Loans

Local authorities can borrow from the Public Works Loans Board (PWLB) provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Director of Finance and S151 Officer. Authorities that are purchasing, or intending to purchase, investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual council and borrowing purpose will be scrutinised by commercial lenders. Further changes to the CIPFA Prudential Code expected in December 2021 are likely to prohibit borrowing for the primary purpose of commercial return even where the source of borrowing is not the PWLB.

The Isle of Wight council is not planning to purchase any investment assets primarily for yield within the next three years and so is able fully access the PWLB.

Revised PWLB Guidance August 2021

HM Treasury published further guidance on PWLB borrowing in August 2021 providing additional detail and clarifications predominantly around the definition of an 'investment asset primarily for yield'. The principal aspects of the new guidance are:

- Capital expenditure incurred or committed to before 26 November 2020 is allowable even for an 'investment asset primarily for yield'.

- Capital plans should be submitted by local authorities via a DELTA return. These open for the new financial year on 1 March and remain open all year. Returns must be updated if there is a change of more than 10%.
- An asset held primarily to generate yield that serves no direct policy purpose should not be categorised as service delivery.
- Further detail on how local authorities purchasing investment assets primarily for yield can access the PWLB for the purposes of refinancing existing loans or externalising internal borrowing.
- Additional detail on the sanctions which can be imposed for inappropriate use of the PWLB loan. These can include a request to cancel projects, restrictions to accessing the PLWB and requests for information on further plans.

Changes to PWLB Terms and Conditions from 8 September 2021

The settlement time for a PWLB loan has been extended from two working days (T+2) to five working days (T+5). In a move to protect the PWLB against negative interest rates, the minimum interest rate for PWLB loans has also been set at 0.01 percent and the interest charged on late repayments will be the higher of Bank of England Base Rate or 0.1 percent.

Municipal Bonds Agency (MBA)

The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities. If the council decides to undertake future borrowing through the MBA, the legal terms and conditions of the arrangement will be thoroughly scrutinised prior to confirming the transaction.

UK Infrastructure Bank

£4 billion has been earmarked for lending to local authorities by the UK Infrastructure Bank, which is wholly owned and backed by HM Treasury. In order to access this funding a local authority will have to take part in a bidding process; however, this lending is not yet available. Loans will be available for qualifying projects at gilt yields plus 0.6 percent, which is 0.2 percent lower than the PWLB certainty rate.

Borrowing Strategy during the period

On 30 September 2021 the council held £226.3 million of loans, (a decrease of £16.4 million when compared to 31 March 2021) as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September 2021 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.21 Balance £m	Net Movement £m	30.09.21 Balance £m	30.09.21 Weighted Average Rate Percent	30.09.21 Weighted Average Maturity (years) Percent
Public Works Loan Board	192.7	(6.4)	186.3	3.23%	15.33
Banks (LOBO)	5.0	-	5.0	4.27%	20.17
Local authorities (short-term)	45.0	(10.0)	35.0	0.15%	0.28
Total Borrowing	242.7	(16.4)	226.3	2.78%	13.11

The council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the council's long-term plans change being a secondary objective.

In keeping with these objectives, no new borrowing was undertaken, while £10.0 million of short-term, and £3.5 million of PWLB existing loans were allowed to mature without replacement. The council considered it to be more cost effective in the near term to use internal resources and as such the council has been able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80 percent. The council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

LOBO loans: The council continues to hold £5 million of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the quarter.

The council, in association with Arlingclose, continues to evaluate the potential to negotiate a settlement of the LOBO loan towards the end of this current financial year.

Other Debt Activity

Although not classed as borrowing, the council has not raised any additional capital finance for Highway Improvements via Private Finance Initiative during this period. Total debt other than borrowing stood at £ 100.8 million on 30 September 2021, taking total debt to £327.1 million

Treasury Investment Activity

Between April 2020 and June 2021, the council received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. The amount received was £121.8 million, which was temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. By 31 July, when all grant schemes were closed, £99.7 million had been paid to local businesses, £11.6 million was returned to government and the remaining £9.5 million is held in reserve for potential repayment, pending the conclusion of the government reconciliation process.

The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves. During the year, the council's investment balances ranged between £94.8 and £67.3 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31/3/21 Balance	2021/22 movement	30/9/21 Balance	30/9/21 rate	30/09/21 WAM days
Banks & Building societies (unsecured)	10.0	1.0	11.0	0.12%	1.00
Isle of Wight Pension Fund	5.5	(0.5)	5.0	0.10%	120.00
Gouvernement including Local Authorities	38.0	(12.5)	25.5	0.10%	276.73
Money Market Funds	14.8	22.2	37.0	0.01%	1.00
	68.3	10.2	78.5	0.27%	60.01

Both the CIPFA Code and government guidance require the council 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 unsuitably low investment income.

Ultra-low short-dated cash rates which have been a feature since March 2020, when Bank Rate was cut to 0.1 percent, have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero, even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee cuts or waivers should result in MMF net yields having a floor of zero, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero.

Given the decision not to replace short-term local authority debt when it matures the council has increased the amount of cash held in MMF's and instant access bank accounts. It is anticipated that the level of funds held in these accounts will reduce before the year end.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2021	4.71	A+	36%	75	0.14%
30.06.2021	4.74	A+	52%	101	0.09%
30.09.2021	4.76	A+	61%	98	0.06%
Similar LA's	4.67	A+	63%	30	0.06%
All LA's	4.69	A+	69%	10	0.08%

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The council also held £40.5 million of such investments in

- directly owned property £35.1 million.
- shared ownership housing £4.0 million.
- loans to local businesses £1.4 million.

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2020/21.

These investments generated £0.6 million of investment income for the council after taking account of direct costs, representing a rate of return of 3.62 percent. This rate of return is related to the directly owned property only.

Treasury Performance

The council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual @ 30/09/21 £m	Actual @ 30/09/21 %	Forecast to 31 March 2021 £m	Full Year Budget	Over / under
Cost of borrowing	(2.20)	2.56%	(8.30)	(9.70)	1.40
PFI & Fin Leases			(8.90)	(8.90)	0.00
Total cost of Borrowing and Debt	(2.20)	2.56%	(17.20)	(18.60)	1.40
Investment Income	0.03	0.09%	0.10	0.20	(0.10)
Total Investment Income	0.03	0.09%	0.10	0.20	(0.10)
Net cost of borrowing	(2.17)		(17.10)	(18.40)	1.30

Estimates for income 2021/22

Investment income in the council's 2021/22 budget was set against a very different economic backdrop. Although the bank rate in February 2021 was the same rate as it is currently, as can be seen from above, the average interest rate has reduced to 0.09 percent as 30 September 2021. This has resulted in a forecast shortfall against the budget of £40,000 as at the end of September.

Compliance

The Director of Finance and S151 Officer reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is also demonstrated in table 7 below.

Table 7: Debt Limits

	H1 Maximum	30.9.21 Actual	2021/22 Operational Boundary	2021/22 Authorised Limit	Complied? Yes/No
Borrowing	234.8	226.3	359.0	450.0	Yes
PFI and Finance Leases	100.8	100.8	111.0	140.0	Yes
Total debt	335.6	327.1	470.0	590.0	Yes

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	H1 Maximum	30.9.21 Actual	2021/22 Limit	Complied? Yes/No
Local authorities & other government entities	39.0	26.0	Unlimited	Yes
Banks (unsecured)	12.0	11.0	24.0	Yes
Banks (operational)	20.9	5.6	12.0	No
Money market funds	40.3	37.4	Unlimited	Yes

As can be seen from the table above, there was an issue of non-compliance in relation to the limits on the operational bank account. There were two occasions where the limit was breached.

The first occasion was on 11 May 2021, when the balance in the account exceeded the limit by £374 thousand. This breach arose due to the level of cash receipts on that particular day. The account balance reverted to below the limit on the following day.

The second occasion was on 27 May 2021, when the balance in the operational bank account was £20.9 million, which is in excess of the £12 million limit. This arose as a large repayment to the Department for Business, Energy and Industrial Strategy of the Covid-19 grant income originally received throughout 2020/21, was delayed by one day. As soon as the issue came clear the Director of Finance and S151 Officer was notified. The account balance reverted to below the limit on the following day.

Treasury Management Indicators

The council measures and manages its exposures to treasury management risks using the following indicators.

Security: The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.9.21 Actual	2021/22 Target	Complied?
Portfolio average credit score	4.76	5.00	Yes

Liquidity: The council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	30.9.21 Actual	2021/22 Target	Complied?
Total cash available within 3 months	48.4	26.5	Yes

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1 percent rise or fall in interests was:

Interest rate risk indicator	30.9.21 Actual	2021/22 Limit	Complied?
Upper limit on one-year revenue impact of a 1 percent <u>rise</u> in interest rates	-£0.2m	-£0.4m	Yes
Upper limit on one-year revenue impact of a 1 percent <u>fall</u> in interest rates	+£0.2m	+£0.4m	Yes

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing: This indicator is set to control the council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	30.9.21 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	48%	50%	0%	Yes
12 months and within 24 months	2%	30%	0%	Yes
24 months and within 5 years	9%	30%	0%	Yes
5 years and within 10 years	16%	75%	0%	Yes
10 years and above	25%	95%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the council's exposure to the risk of incurring losses by seeking early repayment of its investments.

The council has not invested any funds for a period longer than one year.

Further Developments

Revisions to CIPFA Codes

In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These followed the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. In June, CIPFA provided feedback from this consultation.

In September 2021 CIPFA issued the revised Codes and Guidance Notes in draft form and opened the latest consultation process on their proposed changes. These changes are expected to, come into force for the 2022/23 Treasury Management Strategy. The changes include:

- Clarification that
 - o local authorities must not borrow to invest primarily for financial return
 - o it is not prudent for authorities to make any investment or spending decision

that will increase the Capital Financing Requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the council.

- Categorising investments as those
 - o for treasury management purposes,
 - o for service purposes and
 - o for commercial purposes.
- Defining acceptable reasons to borrow money:
 - o financing capital expenditure primarily related to delivering a local council's functions,
 - o temporary management of cash flow within the context of a balanced budget,
 - o securing affordability by removing exposure to future interest rate rises and
 - o refinancing current borrowing, including replacing internal borrowing.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the council's overall financial capacity (i.e., whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).
- Prudential Indicators
 - New indicator for net income from commercial and service investments to the budgeted net revenue stream.
 - Inclusion of the liability benchmark as a mandatory treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding; loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the council's full debt maturity profile.
 - Excluding investment income from the definition of financing costs.
- Incorporating ESG issues as a consideration within TMP 1 Risk Management.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making

MHCLG Improvements to the Capital Finance Framework

MHCLG published a brief policy paper in July 2021 outlining the ways it feels that the current framework is failing and potential changes that could be made. The paper found that “while many authorities are compliant with the framework, there remain some authorities that continue to engage in practices that push the bounds of compliance and expose themselves to excessive risk”.

The actions announced include greater scrutiny of local authorities and particularly those engaged in commercial practices; an assessment of governance and training; a consideration of statutory caps on borrowing; further regulations around Minimum Revenue Provision (MRP) and ensuring that MHCLG regulations enforce guidance from CIPFA and the new PWLB lending arrangements.

A further consultation on these matters is expected soon.

Arlingclose's Economic Outlook for the remainder of 2021/22 (based on the October 2021 interest rate forecast)

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.15	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.10	0.10	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.15	0.15	0.15	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

Arlingclose expects Bank Rate to rise in Q2 2022. We believe this is driven as much by the Bank of England's desire to move from emergency levels as by fears of inflationary

pressure. Investors have priced in multiple rises in Bank Rate to 1 percent by 2024. While Arlingclose believes Bank Rate will rise, it is by a lesser extent than expected by markets.

The global economy continues to recover from the pandemic but has entered a more challenging phase. The resurgence of demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. This is particularly apparent in the UK due to the impact of Brexit.

While Q2 UK GDP expanded more quickly than initially thought, the 'pingdemic' and more latterly supply disruption will leave Q3 GDP broadly stagnant. The outlook also appears weaker. Household spending, the driver of the recovery to date, is under pressure from a combination of retail energy price rises, the end of government support programmes and soon, tax rises. Government spending, the other driver of recovery, will slow considerably as the economy is taken off life support.

Inflation rose to 3.2 percent in August. A combination of factors will drive this to over 4 percent in the near term. While the transitory factors affecting inflation, including the low base effect of 2020, are expected to unwind over time, the MPC has recently communicated fears that these transitory factors will feed longer-term inflation expectations that require tighter monetary policy to control. This has driven interest rate expectations substantially higher.

The supply imbalances are apparent in the labour market. While wage growth is currently elevated due to compositional and base factors, stories abound of higher wages for certain sectors, driving inflation expectations. It is uncertain whether a broad-based increase in wages is possible given the pressures on businesses.

Government bond yields increased sharply following the September Federal Open Market Committee (FOMC) and Monetary Policy Committee (MPC) minutes, in which both central banks communicated a lower tolerance for higher inflation than previously thought. The MPC in particular has doubled down on these signals despite softer economic data. Bond investors expect higher near-term interest rates but are also clearly uncertain about central bank policy.

The MPC appears to be playing both sides, but has made clear its intentions to tighten policy, possibly driven by a desire to move away from emergency levels. While the economic outlook will be challenging, the signals from policymakers suggest Bank Rate will rise unless data indicates a more severe slowdown.