

Performance and Resources Scrutiny Programme 2020/21

Report to: the Office of the Police, Fire and Crime Commissioner for Essex

Title of Report:	Half Year Treasury Management Review 2020/21
Classification:	Official
Chief Officer	Elizabeth Helm, Interim Head of Finance to the PFCC for Essex
Report from:	Corporate Finance
Date of Meeting:	22nd October 2020
Author on behalf of Chief Officer:	Matt Tokley, Corporate Accounting Manager
Date of Approval:	15th October 2020

1. Purpose of the report

- 1.1 To present the half-year treasury review/outturn report for 2020/21. The Chartered Institute of Public Finance and Accountancy (CIPFA) definition of treasury management (TM) is: 'The management of the organisation's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks'.
- 1.2 To present an update regarding investments and borrowings with both UK and, where appropriate, non-UK financial institutions.

2. Recommendations

2.1 The PFCC is recommended to:-

- i) Note the half-year treasury review for 2020/21.
- ii) Maintain the treasury investment limits shown in appendix B.

3. **Executive Summary**

- 3.1 This report provides an overview for how the PFCC's cash balances have been managed so far during 2020/21, and what investments and borrowings (where applicable) have been undertaken during the year.

4. **Introduction/Background**

- 4.1 The OPFCC has 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 PFCC to approve treasury management half-year and annual outturn reports. This report fulfils the OPFCC's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.
- 4.2 The OPFCC's Treasury Management Strategy for 2020/21 was approved at the Strategic Board on the 17th March 2020. The Prudential Code also includes a requirement for the PFCC to provide a Capital Strategy, a summary document covering capital expenditure and financing, treasury management and non-treasury investments. The OPFCC's Capital Strategy, complying with CIPFA's requirement, was approved by the Strategic Board on the 17th March 2020.
- 4.3 The OPFCC has 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 OPFCC's treasury management strategy. The approach to dealing with this risk within the year is covered within the main body of this report.

5.0 **Local Context**

- 5.1 On 31st March 2020, the OPFCC had net investments of £13.79m (£16.42m, 31st March 2019) arising from 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 elements are presented in table 1 below.

Table 1: Balance Sheet Summary

	31/3/20 Actual £m
Capital financing requirement	6.07
Less: usable reserves	(19.84)
Less: working capital deficit	(0.01)
Net (borrowing)/investments	13.79

- 5.2 The treasury management cashbook position as at the 30th September 2020 and the change over the period is shown in table 2 below.

Table 2: Treasury Management Summary

	31/3/20 Balance £m	Movement £m	30/9/20 Balance £m
Long/short-term borrowing	0.00	0.00	0.00
Total borrowing	0.00	0.00	0.00
Long-term investments	0.00	0.00	0.00
Short-term investments	5.50	13.50	19.00
Cash and cash equivalents	8.29	8.06	16.35
Total investments	13.79	21.56	35.35
Total net investments	13.79	21.56	35.35

5.3 Investments

The OPFCC holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year to date the OPFCC's investment balances have ranged between £1.8m and £50.3m due to timing differences between income and expenditure.

5.4 Both the CIPFA Code and government guidance require the OPFCC 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 OPFCC'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.

5.5 The table below summarises the actual investments held at the 31st March 2020 and the 30th September 2020 (excluding accrued interest and other adjustments). Please refer to Appendix A for full details of these investments.

Table 3: Investments

Investments	31/3/20 £m	30/9/20 £m
Call accounts & money market funds	10.76	16.26
Fixed term deposits	5.50	17.50
Lloyds current account	0.44	(0.29)
Total	16.70	33.47

5.6 The increase in investments between the two dates is mainly due to the receipt of £33.39m Police Pensions Top-Up Grant in July 2020. Whilst a large proportion of this income has subsequently been required to cover cashflow commitments, a significant element has also been able to be invested in various instruments. Investments will steadily decrease over the second half of the year, mainly due to the significant investment within the OPFCC's capital programme as well as revenue budget outgoings. In addition, the OPFCC has approximately £6m of capital receipts expected during 2020/21 to cushion the cashflow position. The total forecast cash and investments balance as at the 31st March 2021 is currently expected to be in the region of £5-10m.

- 5.7 The average level of investments over the first six month period of 2020/21 was £25.75m. Excluding balances held on behalf of third parties (e.g. relating to seizures made in accordance with legislation) the average balance reduced to £23.32m. Interest earnings for the period (including the accrued element) were £0.015m, representing an average return of 0.06%. This average rate was a significant reduction from the equivalent rate at the same point last year (0.64%) representing a decrease of 58 basis points reflective of the impact of COVID-19 on the financial markets and the OPFCC's investment strategy. It should be noted that these figures do not include interest in subsequent months for deals already placed at the 30th September.
- 5.8 In 2020/21 the OPFCC expects to receive significantly lower income from its cash and investments, and from its externally managed funds than it did in 2019/20 and earlier years. The forecast investment income for the year is £0.035m, significantly lower than the 2019/20 outturn position and budgeted expectations. However, it should be noted that this budget was set against a very different economic backdrop when the base rate was 0.75% compared to the current position of 0.10%. It is therefore proposed that the 2020/21 budget level of £0.150m is decreased to a revised value of £0.020m as part of the 2021/22 budget setting process. The income received will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact.
- 5.9 Approved financial institutions
The 2020/21 Treasury Management Strategy defines the country, duration and monetary limits for investments, and these criteria are set out in Appendix B.
- 5.10 The PFCC's treasury advisors, Arlingclose, maintain a recommended lending list of UK banks and building societies, the UK Counterparty List. Arlingclose issue the list each month. The version issued on the 30th September 2020 includes the following counterparties:-

Table 4: Approved financial institutions

Arlingclose Recommended UK Counterparty List 30th September 2020	
Banks	Building Societies
Barclays Bank plc and Barclays Bank UK plc	Nationwide Building Society
HSBC Bank plc and HSBC UK Bank plc	
Lloyds Bank plc & Bank of Scotland plc	
NatWest Bank plc, RBS plc and Ulster Bank Ltd	
Santander UK plc	
Standard Chartered Bank	

- 5.11 The above recommended list of UK banks and building societies is significantly less than the equivalent position in 2019/20. This reflects the reduced lending opportunities on offer to the OPFCC. Names of entities that have been removed from the recommended list include Goldman Sachs, Handelsbanken, Coventry

and Leeds Building Society. In addition, the recommended maximum duration for all investments with the remaining counterparties is only 35 days, where this was previously up to 365 days.

- 5.12 In addition to the UK counterparties listed above Arlingclose also issue a list of non-UK counterparties on a monthly basis. These counterparties have not been listed in this report as whilst the 2020/21 Treasury Management Strategy includes non-UK entities they have not been used by the OPFCC in this year to date. Unrated building societies are also omitted from the above table as the OPFCC would not consider these as an investment option.
- 5.13 Any proposed investments would have to meet the criteria as set out in Appendix B before any deal is made with a counterparty on the Arlingclose list. However, the OPFCC will actively take note of current Arlingclose guidance in respect of the current economic climate, which may mean a more risk adverse approach where appropriate. Other factors which will be considered are parent-subsidiary relationships (e.g. essentially exposure to the same counterparty) as well as which counterparties are actively willing to deal in the local authority/public sector market.
- 5.14 Borrowings
The OPFCC'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. Where the cashflow has fallen into a minor deficit on certain dates the OPFCC has continued to consider it to be more cost effective in the short term to use internal resources and/or the current account bank overdraft.
- 5.15 There were no instances of either long-term or short-term external borrowing during the first six month period of 2020/21. As it currently stands it is doubtful that external borrowing will be required for the remainder of 2020/21. Whilst it was originally anticipated that this would be required towards the end of the financial year it is now likely the OPFCC will retain a small cash surplus instead. This is mainly due to additional cashflows not anticipated, including extra grant funding, as well as some timing differentials associated with the Capital programme. Should short-term cashflow deficits arise these will most likely be plugged through the local authority market, where there is currently a plentiful surplus cash at low rates which would not present any significant extra financial burden to the OPFCC. Alternatively, external borrowing will be accessed from the Public Works Loan Board (PWLB) using the pre-approved certainty rate (see paragraph below). The decision for which option is chosen will be based on the term of the loan and the most favourable rate available at the time monies are required.
- 5.16 On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. The Chancellor's March 2020 Budget statement included significant changes to Public Works Loan Board (PWLB) policy and launched a wide-ranging consultation on the PWLB's future direction. The consultation titled "Future Lending Terms" allowed stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It also contained proposals to allow entities that are not involved in "debt for yield" activity to borrow at lower

rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield. The consultation also broached the possibility of slowing, or stopping, individual entities from borrowing large sums in specific circumstances. The consultation closed on 31st July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of 2020 or early 2021.

6.0 COVID-19 and risk management

- 6.1 In a relatively short period since the onset of the COVID-19 pandemic in March and the ensuing enforced lockdown in many jurisdictions, the global economic fallout has been sharp and large. Whilst it was previously the UK's planned exit from the EU which dominated risk management-related activity for treasury management, it is the singular issue of COVID-19 which has fundamentally impacted the OPFCC's treasury management activity and its associated risks. Market reaction has been extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis, and uncharted challenges for governments, business and individuals. The wider issues in the UK and global economy, are set out in further detail in the external context in Appendix C.
- 6.2 The main risks to the OPFCC's cashflows can be categorised as follows:-
- Credit risk – the possibility that a counterparty will fail to meet its contractual obligations, causing a loss to the OPFCC.
 - Liquidity risk – the possibility that the OPFCC might not have the cash available to make contracted payments on time.
 - Market risk – the possibility that an unplanned financial loss will materialise because of changes in market variables such as interest rates or equity prices.
- 6.3 All of the above risks have increased during the first half of 2020/21 however their impact has been mitigated by adhering closely to the advice of its advisors Arlingclose and, where appropriate, amending its investment approach accordingly. It has never been a more prudent and logical time to prioritise security and liquidity of funds over yield, and the OPFCC will continue with this approach until such a time that the economy recovers sufficiently, and financial risks are reduced. The focus on increased risk awareness and mitigation will have a major emphasis in the 2021/22 Treasury Management Strategy.

7.0 Current work and challenges

- 7.1 Continued downward pressure on short-dated cash rates have brought net returns close to zero. On 25th September the overnight, one and two week deposit rates on the Debt Management Account Deposit Facility (DMADF) dropped below zero percent (to -0.03%) for the first time. The returns on money market funds have also dropped significantly over the previous six months, but at this stage negative returns are not the central case of most fund managers.
- 7.2 In the light of the pandemic crisis and the likelihood of unexpected calls on cashflow, the focus on liquid cash is now paramount. Whilst the OPFCC

continues to be in a fairly comfortable position in terms of the liquidity and financial security of its investment portfolio, it continues to be recognised that the OPFCC could do with at least five money market funds, and therefore active steps need to be taken to set up two new funds, in addition to the existing three. This was previously approved by the OPFCC and is now being actively progressed. Whilst it was previously proposed that these should be UK-domiciled due to Brexit-related risk, Arlingclose have now confirmed this is not strictly necessary based on the fact the related investments are diversified across a large market sector. The Corporate Accounting Manager has therefore identified two new funds, the Aviva Sterling Liquidity Fund and the Federated Sterling Prime Fund, which are now in the process of being set up on behalf of the OPFCC. These funds currently rank highly in recent 'risk to reward' benchmarking data for money market funds, provided by Arlingclose. All of these funds will have to continue to meet the minimum AAA-rated criteria.

8.0 Non-Treasury Investments

- 8.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the OPFCC as well as other non-financial assets which the OPFCC holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.
- 8.2 As expected in the Investment Strategy 2020/21 the OPFCC has not held any non-treasury investments in the year to date.

9.0 Compliance

- 9.1 All treasury management activities undertaken during the first half of 2020/21 have complied with the CIPFA Code of Practice however there have been some variations to the OPFCC's approved Treasury Management Strategy, as set out in the following paragraphs. These issues have been chiefly caused by the challenging economic environment during the last six month period.
- 9.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5 below.

Table 5: Debt Limits

	2020/21 Maximum (to date)	30.9.20 Actual	2020/21 Operational Boundary	2020/21 Authorised Limit	Complied? Yes/No
External debt	£0m	£0m	£20m	£25m	Yes

- 9.3 It should be noted that 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. For 2020/21 there have been no instances to date when total debt was above the operational boundary.

- 9.4 Compliance with the approved investment counterparties list is demonstrated in table 6 below.

Table 6: Investment Counterparties

	2020/21 Maximum (to date)	30.9.20 Actual	2020/21 Guideline Limit	Complied?
UK central government (including Debt Management Office & Treasury Bills)	£39.3m	£8.5m	£ unlimited (50 years)	Yes
UK local government	£9.0m	£9.0m	£5.0m per authority (5 years)	Yes
Lloyds Bank account plc (operational bank account) <i>based on credit rating being A- or above during 2020/21 to date</i>	£5.7m	(£0.3m) / (1%)	Higher of 5% or £1.0m (1 year), or up to £5.0m (overnight only)	No (<i>Note A</i>)
UK financial institutions (between A and AAA, liquid investments) – Barclays Bank	£2.5m / 86% (max % where > £1.0m)	£2.5m / 7%	Higher of 5% or £1.0m (unlimited)	Yes (<i>Note B</i>)
UK financial institutions (between A and AAA, liquid investments) – Santander	£2.3m / 15% (max % where > £1m)	£2.3m / 7%	Higher of 5% or £1.0m (unlimited)	Yes (<i>Note B</i>)
Money market funds (AAA rated) – Aberdeen	£5.0m / 60% (max % during year to date)	£4.0m / 12%	10% of total investments	Yes (<i>Note B</i>)
Money market funds (AAA rated) – Insight	£5.0m / 45% (max % during year to date)	£4.0m / 12%	10% of total investments	Yes (<i>Note B</i>)
Money market funds (AAA rated) – Black Rock	£4.0m / 12% (max % during year to date)	£3.5m / 10%	10% of total investments	Yes (<i>Note B</i>)
Money market funds (AAA rated) – Total	£12.0m / 91% (max % during year to date)	£11.5m / 34%	50% of total investments	Yes (<i>Note B</i>)

Notes to Table 6

A) There was one instance where in excess of £5m was retained with Lloyds during the six month period. However, because this was for one day only and the subsequent day's balance dropped below £1m this was not deemed material.

B) Limits with call or notice accounts and money market funds are calculated at the point that monies are invested or withdrawn. Whilst there were some instances when the related balances exceeded the recommended counterparty limits (e.g. not within the guidelines of the 20/21 TM strategy) it was viewed as low-risk as the monies were either accessible on a same-day basis or, in respect of the Notice account only, within a short timescale. Nevertheless, steps will be taken for the remainder of the year to reduce overall exposure to money market funds and keep more tightly within the 50% recommended limit.

C) Limits for counterparties with fixed term deposits are calculated only at the point that monies are invested e.g. by their nature the OPFCC cannot call back these investments during the term specified and therefore the OPFCC cannot legislate against the counterparty's % increasing during this period.

D) Performance in respect of UK entities with a credit rating of A- or below, all non-UK entities, corporates and registered providers have been omitted from the above table as these have not been used to date during 2020/21.

10.0 Treasury Management Indicators

10.1 The OPFCC measures and manages its exposure to treasury management risks using the following indicators.

10.2 **Interest rate exposure:** This indicator is set to control the OPFCC's exposure to interest rate risk. The upper limits on the one year revenue impact of a 1% rise or fall in interest rates was:-

Table 7: Interest rate exposure

	TMS interest rate position	30/9/20 interest rate position	2020/21 forecast impact – max tolerance (if 1% movement)	Complied?
Upper limit on one year revenue impact of a 1% rise in interest rates	0.75%	0.10%	£300,000	n/a (rise less than 1%)
Upper limit on one year revenue impact of a 1% fall in interest rates			(£80,000)	n/a (rise less than 1%)

- 10.3 **Security:** The OPFCC has adopted a voluntary measure of its exposure to credit risk by using minimum credit rating criteria for the counterparties it invests money with. These credit ratings are provided by the three main credit agencies in the UK (Standard & Poors, Fitch and Moody's) and are used in addition to counterparty information received from the OPFCC's treasury management advisors Arlingclose. This approach supersedes the previous measure included within the 2020/21 TMS, as set out in the OPFCC's 2019/20 TM Outturn Report.

Table 8: Minimum credit ratings for counterparties

	30/9/20 Actual	2020/21 Target	Complied?
Minimum credit rating	A	A	✓

- 10.4 **Liquidity:** The OPFCC has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments on a daily basis, without the need for additional borrowing.

Table 9: Liquidity

	30/9/20 Availability	2020/21 Target	Complied?
OPFCC bank account overdraft facility available	£1m	£1m	✓

- 10.5 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the PFCC's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities longer than one year were:

Table 10: Investments longer than one year

	30/9/20 Actual	2020/21 Target	Complied?
Principal invested beyond one year in duration	£0m	£5m	✓

11.0 Equality and/or Human Rights Implications

- 11.1 There is no impact on equality, diversity or human rights.

12.0 Health and Safety Implications

- 12.1 There are no health and safety implications for this report.

13.0 Consultation/Engagement

- 13.1 This paper has been prepared in consultation with Arlingclose, the OPFCC's treasury management advisers.

14.0 Actions for Improvement

14.1 These are noted in sections 7.0 and 9.0.

15.0 Future Work/Development

15.1 This is referred to throughout the report.

16.0 Decisions Required by the Police, Fire and Crime Commissioner

16.1 Please see recommendations section in paragraph 2.0.

Investment position at 31st March and 30th September 2020

31st March 2020

	31/3/20 £000	Start date	Maturity date	Approx. Rate %
Call/notice accounts				
Santander UK PLC	260			0.20%
Barclays Bank PLC	1,500			0.25%
Total	1,760			
Money market funds				
Aberdeen	5,000			0.48%
Insight	4,000			0.31%
Total	9,000			
Fixed term deposits				
Bank of England DMO	5,500	31/03/20	01/04/20	0.05%
Total	5,500			
Other				
Lloyds current account	435			0.10%
Total	435			
Total treasury investments	16,695			

Appendix A (continued)

30th September 2020

	30/9/20 £000	Start date	Maturity date	Approx. Rate %
Call/notice accounts				
Santander UK PLC – call	2,260			0.05%
Barclays Bank PLC – call	1,000			0.05%
Barclays Bank PLC - notice	1,500			0.10%
Total	4,760			
Money market funds				
Aberdeen	4,000			0.11%
Insight	4,000			0.03%
Black Rock	3,500			0.01%
Total	11,500			
Fixed term deposits				
Eastleigh Borough Council	5,000	03/08/20	03/11/20	0.15%
Ashford Borough Council	2,000	26/08/20	26/11/20	0.10%
Blackpool Borough Council	2,000	14/09/20	14/12/20	0.10%
Bank of England DMO	8,500	22/09/20	07/10/20	0.01%
Total	17,500			
Other				
Lloyds current account	(286)			0.02%
Total	(286)			
Total cash & investments	33,474			

Appendix B

Counterparty criteria – Treasury Management Strategy 2020/21

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
Lloyds Bank plc (operational bank account) where credit rating is A- or above	Higher of £1m or 5%* (1 year) An exception applies where planned cash outflows (e.g. salaries or creditor payments) necessitate additional funds being held:- £5m (overnight)	n/a	n/a	n/a	n/a
Between AA- and AAA (fixed-term duration)	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (6 months)	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (6 months)	Higher of £1m or 5%* (1 year) Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (6 months) Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (6 months) Longer exposure - under review
Between A and A+ (fixed term duration)	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (3 months)	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (3 months)	Higher of £1m or 5%* (1 year) Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (3 months) Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (1 year) Non-UK financial institutions: Higher of £1m or 5%* (3 months) Longer exposure - under review

Appendix B (continued)

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
UK central government (including Debt Management Office)	n/a	n/a	£ unlimited (50 years)	n/a	n/a
UK local government	n/a	n/a	£5m per authority (5 years)	n/a	n/a
Lloyds Bank plc (operational bank account) where credit rating is below A-	£1m (overnight)	n/a	n/a	n/a	n/a

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
A- (fixed term duration)	UK financial institutions: Higher of £1m or 5%* (6 months) Non-UK financial institutions: n/a	UK financial institutions: Higher of £1m or 5%* (6 months) Non-UK financial institutions: n/a	Higher of £1m or 5%* (1 year) Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (6 months) Non-UK financial institutions: n/a Longer exposure - under review	UK financial institutions: Higher of £1m or 5%* (6 months) Non-UK financial institutions: n/a Longer exposure - under review
Between A- and AAA (with same day access to funds e.g. call accounts or notice accounts)	Higher of £1m or 5%* (unlimited)	Higher of £1m or 5%* (unlimited)	Higher of £1m or 5%* (unlimited)	Higher of £1m or 5%* (unlimited)	Higher of £1m or 5%* (unlimited)
No published rating	n/a	n/a	n/a	n/a	n/a
Money market funds	£5m per fund (minimum AAA rated), see paragraph 4.16 of the 2020/21 Treasury Management Strategy for further details				
Other pooled funds (including estates trusts, property funds and equity shares)	£5m per fund, but subject to the conditions set out in see paragraph 4.13 of the 2020/21 Treasury Management Strategy				

*Note: the 5% limit is based upon the total exposure to the counterparty concerned. The balance for each counterparty will be rounded down before reviewing this cash limit. For a fixed-term deposit this % is calculated at the time of the deal only whereas for investments with same-day access this limit will be reviewed daily.

External Context

Economic background: The spread of the coronavirus pandemic dominated the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

The Bank of England (BoE) maintained the bank rate at 0.10% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only made up half of the lost output.

The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year on year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% year on year.

In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

Financial markets: Equity markets continued their recovery, with the FTSE 100 and 250 making up around half of their losses from the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

Credit review: After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes in respect of names on the Arlingclose counterparty list. There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on the Arlingclose list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on the Arlingclose counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

Outlook: The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been suppressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

Arlingclose expects the base rate to remain at the current 0.10% level with

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additional monetary loosening in the future most likely through further financial asset purchases (QE). However, further cuts to the base rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the BOE expressly rules out a negative base rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50