Appendix A

Treasury Management Strategy 2025/26

Executive Summary

1. This document sets out the proposed Treasury Management Strategy (TMS) for Somerset Council for 2025/26. The Council recognises that effective treasury management underpins the achievement of its business and service objectives and is essential for maintaining a sound financial reputation. The Council is committed to driving value from all of its Treasury Management activities and to using suitable performance measurement techniques, within the context of effective risk management.

2. This report brings together the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services Code of Practice Revised 2021 Edition (CIPFA TM Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities: Revised 2021 Edition (CIPFA Prudential Code).

3. The Council's current investment portfolio comprises:
   - short-term, cash-based investments as set out in **Table 2**, point 29 below,
   - a Strategic Pooled Funds Portfolio with a current book cost of £112.25m,
   - non-treasury investments comprising commercial property and shareholdings in Council-owned companies.

4. Whilst most of the requirements of the 2018 Department of Levelling Up, Housing, and Communities (DLUHC) Investment Guidance are no longer relevant to cash-based investments (the guidance now overwhelmingly refers to non-treasury investments), it does adhere to DLUHC guidance to prioritise Security, Liquidity and Yield, in that order.

5. As at 31 December 2024, the Council held just over £709m of debt as part of the strategy for funding previous years' capital programmes. **Table 1** in paragraph 27 of this report provides a breakdown of this debt. £41.6m is due to mature before 31st March 2025, with a further £140.1m maturing during 2025-26.

6. The Councils investment balance as at 31 December 2024 stood at just over £218.0m. This is made up of £105.8m cash and £112.25m of pooled funds. Cash balances include approximately £38m held for either external bodies, or entities where the Council is the accountable or administering body.

Recommendations

7. The Executive is asked to endorse the following and recommend approval by Full Council to adopt:
   a) the Treasury Borrowing Strategy and Treasury Investment Strategy for 2025/26 as set out in this report;
   b) the Prudential Treasury Indicators set out in this report; and
   c) **Annex A** as part of the Councils Financial regulations.

Reasons for recommendations

8. As the TMS is a key element of the Budget Framework it is required to be presented to Full Council for approval, following detailed review by the Audit Committee and approval by the Council's Executive.

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Background and Introduction

9. Treasury Management is the administration of cash flows, borrowing and treasury investments, and the management of associated risks. The Council has significant debt and investment portfolios and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. Successful identification, monitoring and control of such risks is a key component of sound financial management.

10. Treasury Management at the Council is conducted within the framework of the CIPFA Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA TM Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA TM Code.

11. Within the Code, the section, 'Prudence in borrowing and investment' is the key update to the code. It states "legitimate examples of prudent borrowing" as:
    - financing capital expenditure primarily related to the delivery of a local authority's functions.
    - temporary management of cash flow within the context of a balanced budget.
    - securing affordability by removing exposure to future interest rate rises.
    - refinancing current borrowing, including adjusting levels of internal borrowing, to manage risk, reduce costs or reflect changing cash flow circumstances, and
    - other treasury management activity that seeks to prudently manage treasury risks without borrowing primarily to invest for financial return.

12. The CIPFA Prudential Code determines that certain acts or practices are not prudent activity for a local authority and incur risk to the affordability of local authority investment. Therefore, in order to comply with the CIPFA Prudential Code, an authority must not borrow to invest primarily for financial return. It is also not considered prudent for local 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 authority. Any expected financial return should either be directly related to the financial viability of the project in question or otherwise incidental to the primary purpose of the scheme.

13. Under Section 3 of the Local Government Act 2003 (duty to determine affordable borrowing limit), a Local Council must have regard to the CIPFA Prudential Code. This code requires the setting of a number of Prudential Indicators, benchmarks within which Treasury and Investment Management, and Capital Financing are managed. The setting of Prudential Indicators for Treasury Management requires Authorities to recognise key implications of their borrowing and investment strategies. These relate to the affordability of overall borrowing limits, the maturity structure of borrowing, and longer-term investments.

14. CIPFA's Prudential Code does not require that existing non-Treasury investments, including property, should be sold, but authorities that have an expected need to borrow should review options for exiting these investments and should summarise the outcomes from such reviews in their annual Treasury Management or Investment Strategies.

15. A review of all non-Treasury investments during 2023/24 concluded that these do not contribute to the new Council's key objectives going forward, and plans have been developed to dispose of these in an orderly manner which achieves best value for money. Sales of £51.3m have been realised as at 7January 2025.

16. Since the Council is not intending to retain these assets over the longer term and has no plans to acquire similar investments in the future, a separate non-Treasury Investments strategy is not considered necessary at the present time. This Treasury Management Strategy sets out how all cash-based resources will be used and managed during 2025/26.

17. In formulating the Treasury Management Strategy, and the setting of Prudential Indicators, the Council adopts the Treasury Management Framework and Policy recommended by CIPFA. These can be found in **Annex A**.

Economic Background

18. The impact on the UK from the government's Autumn Budget, slower expected interest rate cuts, a short-term boost to but modestly weaker economic growth over the medium term, together with the impact from President-elect Trump's second term in office and uncertainties around US domestic and foreign policy, will be major influences on the Authority's treasury management strategy for 2025/26.

19. The Bank of England's (BoE) Monetary Policy Committee (MPC) held Bank Rate at 4.75% at its December 2024 meeting, having reduced it to that level in November and following a previous 25bp cut from the 5.25% peak at the August MPC meeting. At the December meeting, six Committee members voted to maintain Bank Rate at 4.75% while three members preferred to reduce it to 4.50%.

20. The November quarterly Monetary Policy Report (MPR) is forecasting Gross Domestic Product (GDP) growth to pick up to an annual figure of around 1.75% in the early period of the BoE's forecast horizon before falling back. The impact from the Budget pushes GDP higher in 2025 than was expected in the previous MPR, before becoming weaker. Current GDP growth was shown to be zero (0.0%) between July and September 2024 and 0.4% between April and June 2024, a further downward revision from the 0.5% rate previously reported by the Office for National Statistics (ONS).

21. ONS figures reported the annual Consumer Price Index (CPI) inflation rate at 2.6% in November 2024, up from 2.3% in the previous month and in line with expectations. Core CPI also rose, but by more than expected, to 3.6% against a forecast of 3.5% and 3.3% in the previous month. The outlook for CPI inflation in the November MPR showed it rising above the MPC's 2% target from 2024 into 2025 and reaching around 2.75% by the middle of calendar 2025. This represents a modest near-term increase due to the ongoing impacts from higher interest rates, the Autumn Budget, and a projected margin of economic slack. Over the medium-term, once these pressures ease, inflation is expected to stabilise around the 2% target.

22. The labour market appears to be easing slowly. The latest figures reported the unemployment rate rose to 4.3% in the three months to October 2024 and economic inactivity fell to 21.7%. Pay growth for the same period was reported at 5.2% for both regular earnings (excluding bonuses) and for total earnings. Looking ahead, the BoE MPR showed the unemployment rate is expected to increase modestly, rising to around 4.5%, the assumed medium-term equilibrium unemployment rate, by the end of the forecast horizon.

23. The US Federal Reserve has continued cutting interest rates, bringing down the Fed Funds Rate by 0.25% at its December 2024 monetary policy meeting to a range of 4.25%-4.50%, marking the third consecutive reduction. Further interest rate cuts are expected, but uncertainties around the potential inflationary impact of incoming President Trump's policies may muddy the waters in terms of the pace and magnitude of further rate reductions. Moreover, the US economy continues to expand at a decent pace, rising at an (upwardly revised) annual rate of 3.1% in the third quarter of 2024, and inflation remains elevated suggesting that monetary policy may need to remain more restrictive in the coming months than had previously been anticipated.

24. Euro zone inflation rose above the European Central Bank (ECB) 2% target in November 2024, hitting 2.2% as was widely expected and a further increase from 2% in the previous month. Despite the rise, the ECB continued its rate cutting cycle and reduced its three key policy rates by 0.25% in December. Inflation is expected to rise further in the short term, but then fall back towards the 2% target during 2025, with the ECB remaining committed to maintaining rates at levels consistent with bringing inflation to target, but without suggesting a specific path.

25. The Council's Treasury Management Adviser expects the Bank of England's MPC will continue reducing Bank Rate through 2025, taking it to around 3.75% by the end of the 2025/26 financial year. The effect from the Autumn Budget on economic growth and inflation has reduced previous expectations in terms of the pace of rate cuts as well as pushing up the rate at the end of the loosening cycle.

26. The Treasury Management Adviser expects long-term gilt yields to remain broadly at current levels on average (amid continued volatility), but to end the forecast period modestly lower compared to now. Yields will continue to remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will be short-term volatility due to economic and (geo)political uncertainty and events. An economic and interest rate forecast provided by the Treasury Management Adviser is attached at **Annex C**.

Local Context

27. As at 31December 2024 the Council's external long-term debt portfolio stood at just over £709m as in **Table 1** below. However, it is expected that there will be a further borrowing need of up to £100m before 31 March 2025. This is because of refinancing maturing loans (£41.6m) and reduced Council Tax income in February and March, as many households opt to pay over 10 months.

Table 1 – Debt Portfolios as at 31 December 2024

	HRA Balance £m	HRA Rate %	General Fund Balance £m	General Fund Rate %	Total Balance £m	Total Rate %
Local Authority	-	-	32.00	4.66	32.00	4.66
PWLB	153.67	3.16	369.84	4.30	523.51	3.97
Fixed rate	3.00	4.25	57.50	4.75	60.50	4.70
LOBOs	-	-	93.00	4.73	93.00	4.73
Total	**156.67**	**3.18**	**552.34**	**4.44**	**709.01**	**4.16**

28. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while useable reserves and working capital are the underlying resources available for investment. Statutory guidance is that debt should remain below the CFR, except in the short-term.

29. The investment portfolio set out in **Table 2** below, stood at just over £218m at 31 December 2024, although just over £38m of this total was cash held on behalf of other entities, primarily where Somerset Council is the accountable / administering body.

Table 2 – Investment Portfolios as at 31 December 2024

	Balance £m	**%**	**Rate %**
Call / Notice A/cs	-	-	-
Money Market Funds	35.775	16	4.78
Time Deposits / CDs - Banks	-	-	-
Time Deposits - LAs	70.000	32	5.17
Strategic Funds	112.250	51	4.79
Total Investments	**218.025**	**100**	**4.91**

30. CIPFA's Prudential Code recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Although timings of actual cash outflows are not totally predictable, **Table 3** below demonstrates that the Council expects to comply with this recommendation in 2024/25 and in each of the following three financial years.

Table 3 - External Debt and the Capital Financing Requirement (CFR)

	2024/25 Forecast £m	**2025/26 Estimate £m**	**2026/27 Estimate £m**	**2027/28 Estimate £m**
External Debt				
Debt at 1 April	793.009	755.382	854.118	924.426
Estimated change in debt	(37.627)	98.736	70.308	62.266
Gross debt at 31 March	755.382	854.118	924.426	986.692
CFR excluding other long-term liabilities	1,053.497	1,153.809	1,227.735	1,296.859
Under/(Over) Borrowing	298.115	299.691	303.309	310.167

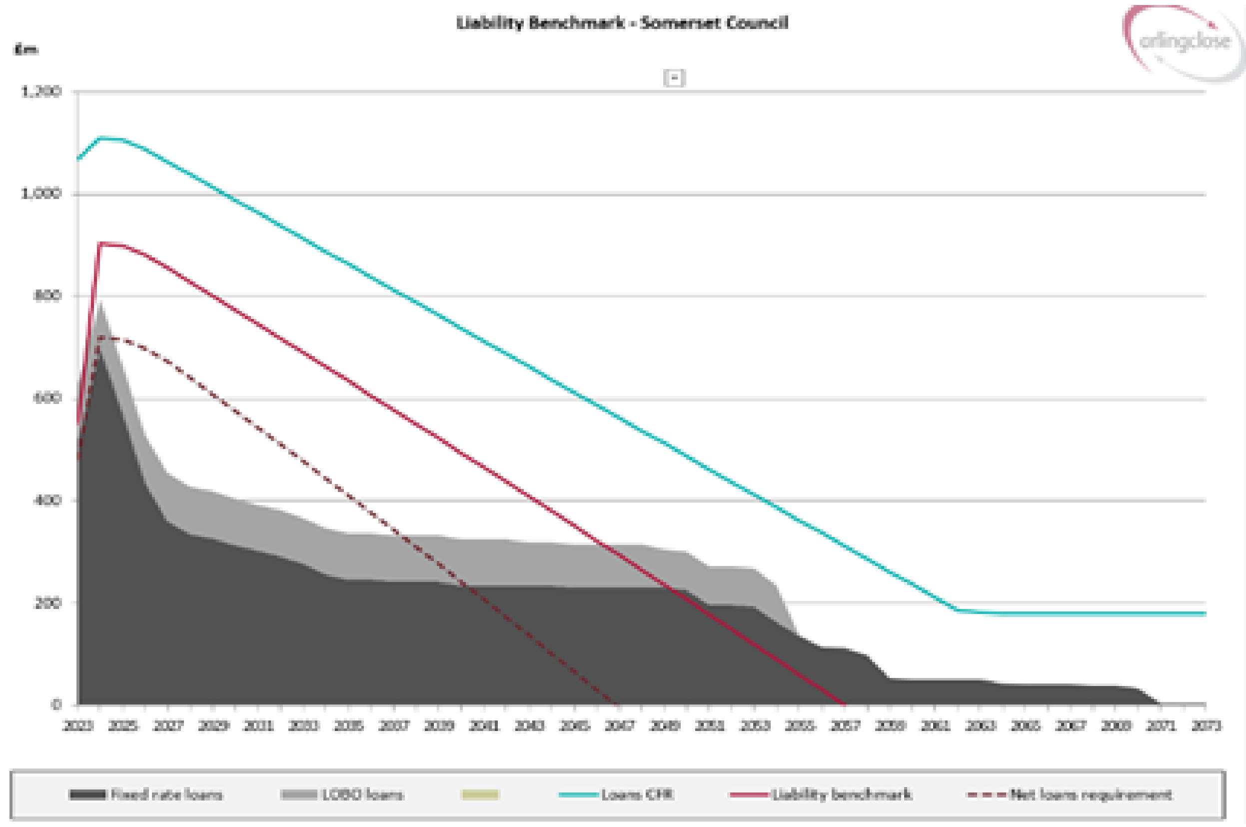
	2024/25 Forecast £m	**2025/26 Estimate £m**	**2026/27 Estimate £m**	**2027/28 Estimate £m**
CFR excluding other long-term liabilities	1,053.497	1,153.809	1,227.735	1,296.859
PFI	38.000	36.000	34.000	32.000
Other long-term liabilities	10.000	10.000	10.000	10.000
Total CFR	1,101.497	1,199.809	1,271.735	1,338.859

Liability Benchmark

31. To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as **Table 3** above, but that cash and investment balances are kept to a minimum level of £75m to maintain sufficient liquidity but minimise credit risk.

32. Following on from the medium-term forecasts in **Table 3** above, the long-term liability benchmark is shown in the chart below together with the maturity profile of the Council's existing borrowing.

Liability Benchmark Graph



33. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

34. The concept is that the chart allows a comparison of current borrowing against the need to borrow, looking at both the amount (on the y axis) and the term (on the x axis). Where actual loans exceed the Liability Benchmark, the authority can make long-term investments for cash flow management or repay loans early; where the Liability Benchmark exceeds loans, the authority can take long-term borrowing or sell investments.

35. There is no requirement to borrow exactly to the Liability Benchmark, but a decision to borrow more or less, or longer or shorter, than the Liability Benchmark implies a deliberate decision to accept additional risk. This may be entirely appropriate if it is accompanied by a reduction in cost, for example through short-term borrowing at lower margins. The Liability Benchmark provides the tool for local authorities to measure this risk and make such risk/reward decisions openly and explicitly.

36. These factors represent significant cash flow, and debt and investment portfolio management for the Council's Officers. In the current financial and economic environment and considering potential influencing factors, it is imperative that the Council has strategies and policies in place to manage flows and balances effectively. The strategies and policies herein state the objectives of Treasury Management for the year and set out the framework to mitigate the risks to successfully achieve those objectives.

Borrowing Strategy

37. The Council's need to borrow for capital purposes is determined by the capital programme. Council Members are aware of the major projects identified by the Capital Strategy and the medium-term financial plan (MTFP). The Council currently (as at 31 December 2024) holds £709.1m of loans, as part of its strategy for funding previous years' capital programmes. The forecasts in Table 3 above shows that the Council will have a need to borrow approximately £231m over the next three years.

38. The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

39. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. The strategy would therefore be to refinance or take any required new debt whilst balancing the needs of budgets and introducing the least possible risk into the long-term debt portfolio.

40. The key drivers of borrowing strategies will be the detail of the disposal of assets within the non-treasury investment portfolio, and any disinvestment of pooled funds. Therefore, it is anticipated that debt for the General Fund will generally be taken mainly in shorter periods, from 1 to 3 years, with a portion possibly to be taken around the 10-12 year, as EIP loans (HRA funding may differ). This will help provide sufficient flexibility so that debt can be paid down as and when non-treasury investments are sold, or holdings in strategic pooled funds are liquidated. Secondly, as interest rates are predicted to fall over the next year to eighteen months, it gives the opportunity to refinance maturing debt at a lower rate.

41. Borrowing rates are expected to continue to reduce slightly (aside from volatility) in the coming months, albeit more slowly and not so low as previously expected. (see forecasts in **Annex C**). It may be most cost effective in the short-term to either use internal resources or to borrow short (1-3 years) via the local authority market. These options will be pursued but might not be too fruitful as capacity for internal borrowing has reduced as investment balances are already significantly reduced, and many local authorities are cautious about others they lend to because of news of financial issues.

42. The Council has previously raised most of its long-term borrowing from the PWLB or via LOBOs with banks. Current policy is not to take further LOBO loans. The Council will continue to assess alternatives to borrowing long-term loans from other sources including banks, pension funds and local authorities, and may wish to investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA TM Code.

43. The Council may also arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

44. The use of Call Accounts and Money Market Funds (MMFs) will continue for short-term liquidity; however, it may be appropriate and/or necessary to borrow short-term (1 week to 3 months) to cover cash flow fluctuations. Where this is deemed advantageous, short-term funds will be obtained from the money market using the services of a panel of money market brokers.

Sources of borrowing

45. Approved sources of borrowing are cited in the TMPs and are currently as follows:
    - HM Treasury's PWLB lending facility (formerly the Public Works Loan Board) including the National Wealth Fund Ltd (formerly UK Infrastructure Bank Ltd) which is dealt via the PWLB and novated to the National Wealth Fund Ltd.
    - Other Local Authorities.
    - Long term money market loans including forward starting loans (Local Authority or Commercial lender).
    - Temporary money market loans (up to 364 days, Local Authority or Commercial lender).
    - Bank overdraft.
    - Loans from bodies such as the European Investment Bank (EIB).
    - Stock issues.
    - Deferred purchase.
    - Private Finance Initiative.
    - Operating and finance leases.
    - Hire purchase.
    - Sale and leaseback.
    - Internal resources.

46. Variable rate loans currently mitigate the cost of carry. Shorter-dated Equal Instalment of Principal (EIP) loans can be cheaper than loans paid on maturity and are repaid systematically in equal instalments over their life. Both will be actively considered, as will shorter dated loans (1-3 years) from other Local Authorities.

47. No new borrowing will be in the form of LOBOs. Interest rates have risen from historical lows, and there remains a possibility that lenders will exercise their options. The Council will continue with the current policy not to accept any option to pay a higher rate of interest on its LOBO loans and will exercise its own option to repay the loan should a lender exercise an option. This would reduce refinancing risk in later years.

48. The Council will also investigate opportunities to repay where a lender is looking to exit the LOBO by selling the loan. This would be undertaken in conjunction with the Council's Treasury Management Adviser. The Council may utilise cash resources for repayment or may consider replacing any loan(s) by borrowing from other sources. Depending on prevailing rates and the amount to be repaid, new loans might be taken over a number of maturities. The 'Maturity Structure of Borrowing' indicators have been set to allow for this contingency strategy.

Debt rescheduling

49. The PWLB allows Local Authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates relative to the rate of the loan. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

50. The rise in interest rates from historical lows means that more favourable debt rescheduling opportunities may arise than in previous years, however no specific debt rescheduling opportunities are being considered at the present time.

Treasury Investment Strategy

51. As a result of the review of strategic pooled funds, there will be disinvestment from this portfolio. The scale, timing, and identification of individual funds to be sold will depend on market conditions, potential gains or losses, and diversification.

52. As minimising debt has been a Council priority during 2024, investment balances have reduced significantly. Total investment balances as at 31 December were just over £218m, of which £112.25 was pooled funds. Cash balances of just under £106m included just over £38m of cash held on behalf of other entities, and approximately £28m of 2 large payments in from BT Openreach (most of which will need to be paid out before year-end).

53. There is little further capacity for passive borrowing, i.e. internal borrowing to fund capital expenditure, and balances are being minimised to provide monthly working capital. It is envisaged that balances will be kept minimal throughout 2025/26 in order to minimise external debt.

Objectives

54. The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest 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.

55. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested. The Council aims to be a responsible investor and will consider environmental, social, and governance (ESG) issues when investing.

Strategy

56. As demonstrated by the liability benchmark above, the Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments.

ESG policy

57. ESG (Environmental, Social, and Governance) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. The Council will look to develop a more effective ESG policy as this area develops.

Business models

58. Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Implementation

59. The Interim Chief Finance Officer (Section 151 Officer) under delegated powers set out in the Council's Constitution will undertake the most appropriate form of investment management in keeping with the contents of this Strategy following its approval by elected members and in particular with its investment objectives, income and risk management requirements and Prudential Indicators.

60. The Interim Chief Finance Officer (Section 151 Officer) in turn delegates responsibility for implementing this agreed policy to Treasury Management Officers. This is done by using only the agreed investment instruments, and credit criteria below and as set out in **Annex B**. As is current procedure, the use of a new instrument or counterparty would be proposed in conjunction with the Council's Treasury Advisorsand specifically authorised by the Interim Chief Finance Officer (Section 151 Officer).

Approved Investments

61. The list below shows currently approved instruments, with a brief description of current and potential investment instrument characteristics underneath.

    - Business Reserve Accounts and term deposits
    - Deposits with other Local Authorities.
    - Low Volatility Net Asset Value (LVNAV) Money Market Funds
    - The Debt Management Office (DMO)
    - Variable Net Asset Value (VNAV) Money Market Funds.
    - Gilts and Treasury Bills.
    - Certificates of Deposit with Banks and Building Societies
    - Covered Bonds and Reverse Repurchase Agreements (Repos) present an opportunity to invest short-term with banks on a secured basis and hence be exempt from bail-in
    - Pooled Funds. As stated previously, holdings in these investments will be reduced rather than added to, but nonetheless are approved for use during the year.

    Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and rated building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

    Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

    Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

    Pooled Funds: Shares or units in diversified investment vehicles. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period are currently being disinvested.

Credit outlook

62. Credit Default Swap (CDS) prices have typically followed a general trend downwards during 2024, reflecting a relatively more stable financial period compared to the previous year. Improved credit conditions in 2024 have also led to greater convergence in CDS prices between ringfenced (retail) and non-ringfenced (investment) banking entities again.

63. Higher interest rates can lead to a deterioration in banks' asset quality through increased loan defaults and volatility in the value of capital investments. Fortunately, the rapid interest rate hikes during this monetary tightening cycle, while putting some strain on households and corporate borrowers, has not caused a rise in defaults, and banks have fared better than expected to date, buoyed by strong capital positions. Low unemployment and robust wage growth have also limited the number of problem loans, all of which are positive in terms of creditworthiness.

64. Moreover, while a potential easing of US financial regulations under the new Presidency may aid their banks' competitiveness compared to institutions in the UK and other regions, it is unlikely there will be any material impact on the underlying creditworthiness of the institutions on the counterparty list maintained by the Council's Treasury Management Adviser.

65. Overall, the institutions on the Council's Treasury Management Adviser's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Approved counterparties – Credit Rated

66. The Council maintains a restricted list of financial institutions to be used as counterparties, and in accordance with the credit criteria set out in **Annex B**. Any proposed additions to the list must be approved by the Interim Chief Finance Officer (Section 151 Officer).

Approved counterparties – Non-Credit Rated

67. As investment decisions are never made solely based on credit ratings, and some institutions may not have ratings at all, account will be taken of any relevant credit criteria in **Annex B**, and any other relevant factors including advice from the Council's Treasury Management Adviser for the approval of individual institutions. Again, this will be specifically authorised by the Interim Chief Finance Officer (Section 151 Officer).

Credit rating

68. The Council has constructed and will maintain a counterparty list based on the criteria set out in **Annex B**. The minimum credit quality is proposed to be set at A- or equivalent. The credit standing of institutions (and issues if used) will be monitored and updated on a regular basis.

69. The Council will continuously monitor counterparties creditworthiness. All three credit rating agencies' websites will be visited frequently, and all ratings of proposed counterparties will be subject to verification on the day of investment (MHCLG guidance states that a credit rating agency is one of Standard & Poor's, Moody's Investor Services Ltd, and Fitch Ratings Ltd). All ratings of currently used counterparties will be reported to the regular treasury management meeting, where proposals for any new counterparties will be discussed.

70. New counterparties must be approved by Interim Chief Finance Officer (Section 151 Officer) before they are used. Any changes to ratings that put the counterparty below the minimum acceptable credit quality whilst there is a deposit, or a marketable instrument will be brought to the attention of the Interim Chief Finance Officer (Section 151 Officer) immediately, and an appropriate response decided on a case-by-case basis. Sovereign credit ratings will be monitored and acted on as for financial institution ratings. Investment limits are set by reference to the lowest published long-term credit rating from the three rating agencies mentioned above. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

Other information on the security of investments

71. The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including those outlined below.

- Credit Default Swap prices.
- Financial Statements.
- Information on potential government support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Analysis and advice from the Council's treasury management advisor.
- Other macroeconomic factors

72. It remains the Council's policy to suspend or remove institutions that still meet criteria, but where any of the factors above give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

73. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This may cause a reduction in the level of investment income earned but will protect the principal sum invested.

Investment limits

74. Investment limits are set out in **Annex B**. In setting criteria in Annex B, account is taken of both expected and possible balances, the availability and accessibility of the various instruments to be used, and their security, liquidity, and yield characteristics.

Liquidity management

75. The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

Treasury Management Prudential Indicators

76. The Council measures and manages its exposures to Treasury Management risks using specific Prudential Indicators which are set out below and should be adopted as per the recommendations set out in this report:
    - The Authorised Limit and Operational Boundary,
    - The Maturity Structure of Borrowing,
    - Principal sums invested for periods longer than a year,
    - Credit Risk Indicators, and
    - Liability Benchmark.

77. Other Prudential Indicators which relate primarily to capital investment and capital funding are set out in the Capital Strategy.

Authorised limit and Operational Boundary

78. The Council is required to set an authorised limit and an operational boundary for managing external debt. The authorised limit is the maximum external debt (net of investments) that may be incurred in the specified years. The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt according to probable, not all possible events. The operational boundary has been set to be in line with the CFR and is therefore consistent with the maximum level of external debt projected in the Capital Strategy.

*Table 4 – Operational Debt Boundary and Authorised Debt Limit**

	2024/25 limit £m	2025/26 limit £m	2026/27 limit £m	2027/28 limit £m
Operational boundary:				
Borrowing	1,000.000	955.000	1,025.000	1,087.000
PFI	35.000	36.000	34.000	32.000
Operational boundary – total debt	1,035.000	991.000	1,059.000	1,119.000
Authorised limit:				
Borrowing	1,050.000	1,005.000	1,075.000	1,137.000
PFI	35.000	36.000	34.000	32.000
Authorised limit – total debt	1,085.000	1,041.000	1,109.000	1,169.000

*Includes borrowing for both General Fund and HRA

Maturity Structure of Borrowing

79. The Council has set for the forthcoming year, both the upper and lower limits with respect to the maturity structure of its borrowing. The calculation is the amount of projected borrowing maturing in each period, expressed as a percentage of the total projected borrowing. CIPFA TM Code guidance for the 'maturity structure' indicator states that the maturity of LOBO loans should be treated as if their next option date is the maturity date.

80. The 'maturity structure of borrowing' indicators have been set with regard to this and having given due consideration to refinancing the significant short-term debt that will mature, possible new borrowing, current interest rate expectations, and the possibility of rescheduling or prematurely repaying loans outlined in the borrowing strategy. The bands and limits give the required flexibility to be able to deliver the borrowing strategy in any of the challenging scenarios that may evolve. The changes to last year are that the >12 months and within 24 months, and the 5-10-year bands' lower limits have been raised by 5%, and the 30-40 year lower limit has been lowered by 5%.

81. Proposed limits are:

	Upper limit %	**Lower limit %**
Under 12 months	50	15
>12 months and within 24 months	30	5
>24 months and within 5 years	25	5
>5 years and within 10 years	25	5
>10 years and within 20 years	25	0
>20 years and within 30 years	20	0
>30 years and within 40 years	30	5
>40 years and within 50 years	15	0
>50 years	5	0

Long-term treasury management investments

82. 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.

83. The prime policy objectives of local authority investment activities are the security and liquidity of funds, and authorities should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider the return on their investments; however, this should not be at the expense of security and liquidity. It is therefore important that authorities adopt an appropriate approach to risk management with regards to their investment activities.

	2025/26 £m	2026/27 £m	2027/28 £m
Prudential Limit for principal sums invested for periods longer than 1 year	115	115	115

84. Long-term investments with no fixed maturity date include strategic pooled funds but exclude Money Market Funds and bank accounts with no fixed maturity as these are considered short-term. As the Council already holds a portfolio of £112.25m of pooled funds, a prudential indicator of slightly more than this amount is deemed necessary for all years. This should reduce over time, due to disinvestment of this portfolio, but exact amounts and timings are not known at this time. The sums indicated in this indicator do not include any investment in non-Treasury Investments.

Credit Risk Indicator

85. The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating / credit score of its in-house 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 (in conjunction with the Council's Treasury Management Adviser) and will be calculated quarterly.

	Target
Portfolio average credit rating (score)	A (6.0)

Liability Benchmark

86. A new Prudential Indicator, the Liability Benchmark was introduced in 2023/24. Whilst it gives no specific numbers as benchmarks, it is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

87. The liability benchmark informs both borrowing and investment decisions and is outlined in paragraphs 32-37 above.

Derivative Instruments

88. As part of its published TM strategy, the Council must explicitly state whether it plans to use derivative instruments to manage risks. The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

89. At present the Council does not intend to use derivatives. Should this position change, the Council would seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require Full Council approval.

External Service Providers

90. The Code states that the use of external service providers should be reviewed regularly and that services provided are clearly documented, and that the quality of that service is controlled and understood.

91. The Council recognises, as per CIPFA guidance, that, "the overall responsibility for treasury management must always remain with the Council". So as not to place undue reliance on treasury advisors and other external services, the council has always sourced its own information, performed its own analysis of market and investment conditions, and the suitability of counterparties. It continues to do so through embedded practices, thereby maintaining the skills of the in-house team to ensure that services provided can be challenged, and that undue reliance is not placed on them.

Member Training

92. All public service organisations should be aware of the growing complexity of treasury management in general, and its application to the public services in particular. Modern treasury management, and particularly non-treasury investments demand appropriate skills.

93. All Council Members receive introductory training, which includes an overview of the Treasury Management function. Further Treasure Management training could be arranged during the 2025/26 financial year,.

94. Through contacts with the CIPFA Treasury Management Forum and its independent Treasury Advisors, the Council could also facilitate training via an independent third party. Officers also have contacts within a number of money market brokers and fund managers who could provide training if required. Alternatively, information sheets could be prepared and made available to help keep members abreast of current developments.

Markets in Financial Instruments Directive II (MiFID II)

95. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3 January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met. This included having an investment balance of at least £10m and the person(s) authorised to make investment decisions on behalf of the Council have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved. Each regulated Financial Services firm undertakes a separate assessment with ongoing compliance.

96. The Council continues to meet the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

Housing Revenue Account

97. On 1st April 2012, the legacy Councils notionally split each of their existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account.

Links to Council Plan and Medium-Term Financial Plan

98. Treasury Management supports the range of business and service level objectives that together help to deliver the Somerset County Plan.

Other options considered

99. None. The adoption of the TMS is a regulatory requirement.

Scrutiny comments / recommendations:

100. The Audit Committee is responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. It is currently anticipated that this TMS will be presented to the Committee for review on 30 January 2025. The Audit Committee is also responsible for monitoring the implementation of Treasury Management policies and activity, once agreed.

Consultation and feedback

101. None. The adoption of the TMS is a regulatory requirement.

Financial and Risk Implications

102. The budget for investment income in 2025/26 is £6.5m, based on an average investment portfolio of £175m at an average return of 3.7% (these figures are net of balances held on behalf of third parties). The General Fund budget for debt interest in 2025/26 is £27m, based on average borrowing of £605m at an average interest rate of 4.5% (note 5.25% for new debt). In addition, the MRP budget (including PFI adjustments) is £26m.

103. There are also additional debt and interest cost charges to the HRA, which are funded mainly from housing rents. If actual levels of investments or borrowing, or actual interest rates, differ from the forecast, performance against budget will be correspondingly different.

104. The debt interest budget includes provision for interest for debt taken under the current Capitalisation Directive. Any debt taken by the Council to finance a Capitalisation Directive must be taken from PWLB and must be financed over 20 years.

105. The TMS is the Council’s document that sets out strategy and proposed activities to conduct Treasury Management activity while mitigating risks.

Legal and Procurement Implications

106. Treasury Management must operate within specified legal and regulatory parameters as set out in the summary, and in more detail in the Treasury Management Practices (TMPs).

Appendix A

Background papers

- Local Government Act 2003 – Guidance under section 15(1)(a) 3rd Edition, effective from 1 April 2018.
- CIPFA 'Treasury Management in the Public Services' Code of Practice 2021.
- The CIPFA Prudential Code for Capital Finance in Local Authorities 2021.

For sight of individual background papers please contact the report author.

Annexes

- Annex A: Treasury Management Policy Statement
- Annex B: Somerset Council Lending Counterparty Criteria 2025/26
- Annex C: Economic Outlook & Interest Rate Forecast

Annex A

Treasury Management Policy Statement

Introduction and Background

1.1 The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the CIPFA TM Code), as described in Section 5 of the Code.

1.2 The Council will create and maintain, as the cornerstones for effective treasury and investment management:

- A treasury management policy statement stating the policies, objectives and approach to risk management of its treasury management activities.
- Suitable treasury management practices (TMPs) setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
- Investment management practices (IMPs) for investments that are not for treasury management purposes.

The content of the policy statement, TMPs and IMPs will follow the recommendations contained in Sections 6, 7 and 8 of the CIPFA TM Code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the CIPFA TM Code's key principles.

1.3 The Council (i.e. Full Council) will receive reports on its treasury and investment management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close in the form prescribed in its TMPs and IMPs.

1.4 The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to Executive and for the execution and administration of treasury management decisions to the Section 151 Officer, who will act in accordance with the organisation's policy statement, TMPs and IMPs, and if they are a CIPFA member, CIPFA's Standard of Professional Practice on treasury management.

1.5 This organisation nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

Appendix A

Policies and Objectives of Treasury Management Activities

2.1 The Council defines its treasury management activities as:

"The management of the organisation's borrowing, investments and cash flows, including 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."

2.2 This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

2.3 This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

2.4 The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken, and the type of borrowing should allow the Council transparency and control over its debt.

2.5 The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Council's investments followed by the yield earned on investments remain important but are secondary considerations.

Annex B

Somerset Council Lending Counterparty Criteria 2025/26

The following criteria will be used to manage counterparty risks to Somerset Council investments for new deposits / investments from 1 April 2025.

Please note that the limits in this annex apply only to Treasury Management Investments.

Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

Deposits
Any Financial Institution that is authorised by the Prudential Regulation Authority to accept deposits in the UK or is a UK Building Society can be lent to, subject to the rating criteria below at the time of the deposit.

Marketable Instruments
Any bank, other organisation, or security whose credit ratings satisfy the criteria below.

Rating of Counterparty or Security
<u>Deposits or instruments of less than 13 months duration (refer to long-term ratings)</u>
Fitch A- or above
S&P A- or above
Moody's A3 or above

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum at least two ratings of the three above will be £15m (the same as for 2024/25). This is approximately 5.7% of average investment balances, or 10.2% of average cash balances up to 31 December. The % may be significantly less if borrowing up to the CFR is taken early in the year.

The allowed deposit amounts above are the single maximum per counterparty at any one time, and that counterparty or security must be rated as above or better by at least two of the three agencies. Short-term ratings will be monitored and considered in relative rather than absolute terms.

It remains the Council's policy to suspend or remove institutions that still meet criteria, but where any of the other factors below give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors. Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

Appendix A

Operational Bank Accounts
As the Council's current bankers, Nat West are currently within the minimum criteria. If they should fall below criteria, the instant access Call Account facility may still be used for short-term liquidity requirements and business continuity arrangements. This will generally be for smaller balances where it is not viable to send to other counterparties or in the event of unexpected receipts after the daily investment process is complete. Money will be placed in the instant access Nat West call account overnight.

Public Sector Bodies
Any UK Local Authority or Public Body will have a limit of £10m (The same as for 2024/25) and a maximum maturity of 2 years.

The UK Government, including Gilts, T-Bills, and the Debt Management Office (DMADF) will be unlimited in amount and duration.

The table below gives a definition and approximate comparison of various ratings by the three main agencies: -

Definitions of Rating Agency Ratings

	Fitch		Moody's		S&P	
Short-Term	F1+	Exceptionally strong	P-1	Superior	A-1+	Extremely strong
	F1	Highest quality			A-1	Strong
	F2	Good quality	P-2	Strong	A-2	Satisfactory
	F3	Fair quality	P-3	Acceptable	A-3	Adequate
	B	Speculative	NP	Questionable	B and below	Significant speculative characteristics
	C	High default risk				
	(+) or (-)		(1,2, or 3)		(+) or (-)	
Long-Term	AAA	Highest quality	Aaa	Exceptional	AAA	Extremely strong
	AA	V High quality	Aa	Excellent	AA	Very strong
	A	High quality	A	Good	A	Strong
	BBB	Good quality	Baa	Adequate	BBB	Adequate capacity
	BB	Speculative	Ba	Questionable	BB and below	Significant speculative characteristics
	B	Highly Speculative	B	Poor		
	CCC	High default risk	Caa	Extremely poor		

Financial Groups
For Financial Groups (where two or more separate counterparties are owned by the same eventual parent company) investments can be split between entities, but an overall limit equal to the highest rated constituent counterparty within the group will be used.

Country Limits
Excluding the UK, there will be a limit of £20m collectively to all organisations domiciled in one Sovereign Country (the same as for 2024-25). This is approximately 7.6% of average investment balances, or 13.7% of average cash balances up to 31st December. The % may be significantly less if borrowing up to the CFR is taken early in the year.

Money Market Funds
Any LVNAV Money Market Fund used must be rated by at least two of the main three ratings agencies and must have the following ratings.

Fitch AAAmmf	Moody's Aaa-mf	Standard & Poor's AAAm

Subject to the above, deposits can be made with the following limits:
The lower of £15m or 0.5% of the total value for individual Funds.

VNAV and other Pooled Funds
As a result of the review of strategic pooled funds, there will be disinvestment from this portfolio. The scale, timing, and identification of individual funds to be sold will depend on market conditions, potential gains or losses, and diversification.

It may be decided that a percentage of pooled funds are retained to provide diversification should cash interest rates fall significantly again. Whilst it is difficult to state absolute or percentage limits at present, amounts would be in relation to core balances and reserves and will be significantly below levels currently held.

Other Indicators
The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including those outlined below.

- Credit Default Swap prices.
- Financial Statements.
- Information on potential government support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Analysis and advice from the Council's treasury management advisor.
- Other macroeconomic factors

Annex C

Council's Treasury Management Adviser's Economic Outlook & Interest Rate Forecast

Interest rate forecast

In line with our forecast, Bank Rate was held at 4.75% in December.

The MPC will reduce Bank Rate in a gradual manner. We see a rate cut in February 2025, followed by a cut alongside every Monetary Policy Report publication, to a low of 3.75%.

Long-term gilt yields have risen to reflect both UK and US economic, monetary and fiscal policy expectations and increases in bond supply. Volatility will remain elevated as the market digests incoming data for clues around the impact of policy changes.

This uncertainty may also necessitate more frequent changes to our forecast than has been the case recently.

The risks around the forecasts lie to the upside over the next 12 months but are broadly balanced in the medium term

	Current	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27	Jun-27	Sep-27
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.75	4.75	4.50	4.25	4.00	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Downside risk	0.00	0.00	-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
3-month money market rate													
Upside risk	0.00	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.95	4.80	4.60	4.35	4.10	3.90	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside risk	0.00	0.00	-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
5yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.30	4.20	4.10	4.05	3.95	3.90	3.90	3.90	3.95	4.00	4.05	4.05	4.05
Downside risk	0.00	-0.40	-0.50	-0.60	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65
10yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.41	4.40	4.35	4.35	4.35	4.30	4.30	4.30	4.35	4.35	4.35	4.35	4.35
Downside risk	0.00	-0.40	-0.50	-0.60	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65
20yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.84	4.80	4.75	4.70	4.65	4.65	4.65	4.65	4.65	4.65	4.65	4.65	4.65
Downside risk	0.00	-0.40	-0.50	-0.60	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65
50yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.35	4.50	4.45	4.40	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Downside risk	0.00	-0.40	-0.50	-0.60	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65

PWLB Standard Rate = Gilt yield + 1.00%
PWLB Certainty Rate = Gilt yield + 0.80%
PWLB HRA Rate = Gilt yield + 0.40%
National Wealth Fund (NWF) Rate = Gilt yield + 0.40%

Appendix A

Underlying assumptions

As expected, the Monetary Policy Committee (MPC) held Bank Rate at 4.75% in December, although, with a 6-3 voting split and obvious concerns about economic growth, presented a much more dovish stance than had been expected given recent inflationary data.

The Budget measures remain a concern for policymakers, for both growth and inflation. Additional government spending will boost demand in a constrained supply environment, while pushing up direct costs for employers. The short to medium-term inflationary effects will promote caution amongst policymakers.

UK GDP recovered well in H1 2024 from technical recession, but underlying growth has petered out as the year has progressed. While government spending should boost GDP growth in 2025, private sector activity appears to be waning, partly due to Budget measures.

Private sector wage growth and services inflation remain elevated, and wage growth picked up sharply in October. The increase in employers' NICs, minimum and public sector wage levels could have wide ranging impacts on private sector employment demand and costs, but the near-term impact will likely be inflationary as these additional costs get passed to consumers.

CPI inflation rates have risen due to higher energy prices and less favourable base effects. The current CPI rate of 2.6% could rise further in Q1 2025. The Bank of England (BoE) estimates the CPI rate at 2.7% by year end 2025 and to remain over target in 2026.

The MPC re-emphasised that monetary policy will be eased gradually. Despite recent inflation-related data moving upwards or surprising to the upside, the minutes suggested a significant minority of policymakers are at least as worried about the flatlining UK economy.

US government bond yields have risen following strong US data and uncertainty about the effects of President Trump's policies on the US economy, particularly in terms of inflation and monetary policy. The Federal Reserve pared back its expectations for rate cuts in light of these issues. Higher US yields are also pushing up UK gilt yields, a relationship that will be maintained unless monetary policy in the UK and US diverges.