Report to the Cabinet

Report reference: C-061-2011/12
Date of meeting: 12 March 2012

Epping Forest District Council

Portfolio: **Finance & Economic Development**

Subject: **HRA Self-Financing – Proposed Debt Portfolio Modelling**

Responsible Officer: **Brian Moldon** **(01992 564455).**

Democratic Services Officer: **Gary Woodhall** **(01992 564470).**

Recommendations/Decisions Required:

(1) That Cabinet approves the borrowing of £185.5m to finance the payment to the Department for Communities and Local Government for Self-Financing;

(2) That the additional borrowing above the HRA CFR remains with the HRA to finance, in order to maintain the flexibility in the HRA capital programme to carryout the enhanced programme on the housing stock and to allow for any expansion in the new build programme;

(3) That the Council borrows entirely from the Public Works Loans Board (PWLB);

(4) That in accordance with the Treasury Management Strategy adopted by Council, the charge for any General Fund (GF) borrowing from the Housing Revenue Account (HRA) is based on the investment rate;

(5) That the actual debt portfolio to be decided by the Finance & Economic Development Portfolio Holder and the Director of Finance & ICT after considering advice from Arlingclose (the Council's Treasury Management Advisors); and

(6) That the Chairman of Council be requested to waive the call-in arrangements for this decision due to its urgency as any delay would prejudice the Council's interest.

Executive Summary:

In December 2011, the Cabinet considered the Housing Revenue Account (HRA) Business Plan and made recommendations on items that should be included within the plan. Following that meeting, officers started to review the cash flow position of the plan to identify when resources would be available and Arlingclose undertook an exercise to consider how the Debt Portfolio should be constructed.

Arlingclose have now issued a report to the Council containing recommendations on how the Debt Portfolio should be constructed and a decision is necessary to implement the borrowing by the deadline of 26 March 2012.

Reasons for Proposed Decision:

The Council needs to pay the Department for Communities and Local Government (CLG) £185,456,000 on the 28 March 2012. However, the Council does not have the internal resources to finance this payment and therefore, will need to borrow the money from the PWLB. The Council must register its requirements with the PWLB on 26 March 2012.

Other Options for Action:

Within the report are the two borrowing solutions outlined by Arlingclose, these being borrowing the whole amount or borrow up to the HRA CFR. However, there are a number of other options open to the Council that are somewhere between the two, this would involve using some of the Council's internal resources.

Report:

Introduction

1. In March 2012, the Government will be introducing a major, long-term change in the way that local authority's Housing Revenue Accounts (HRAs) are funded. This will move away from the current HRA Subsidy System where we pay in excess of £11m per annum to a new HRA Self Financing System where the Council will make a one-off payment to the Government of £185.5m.

2. In December 2011, the Cabinet considered a proposed HRA Financial Plan and made recommendations on a number of proposals, including rents levels, housing improvements and service enhancements and to increase capital expenditure to maintain the Council's stock to a higher standard.

3. Following that meeting officers analysed the cash flow position of the amended plan and provided Arlingclose (the Council's treasury advisors) with a cash flow position of when resources would be available to contribute to repaying the debt. They have now come back to officers with their recommendations on a possible debt portfolio consisting of:

- Where to borrow the money from;
- The type of repayment method to be used;
- Whether to use Fixed or Variable rate;
- The length of loans; and
- The amount to borrow.

Where to Borrow the Money From

4. The first call for any local authority to borrow is with the Public Works Loan Board (PWLB). This is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. Its function is to lend money from the National Loans Fund to local authorities and other prescribed bodies.

5. However, the borrowing for a number of authorities was so high that at the October 2010 pre-spending review, the Government increased the margin on PWLB loans by around 85 bases point (making loans 1% above Gilts). This made funding from alternative sources possibly cheaper than PWLB and a number of authorities (including ourselves) looked into the possibility to fund the payment for self financing through loans from banks or bonds from the markets.

6. The Government announced on 19 September 2011 that rates for local authorities to borrow for Housing Self Financing only, will be at a lower pre-spending review levels (October 2010). This made all other borrowing from banks and the markets unattractive and therefore made the decision easy for the Council to decide to borrow entirely from the PWLB.

The Type of Repayment Method to be Used

7. The PWLB offers three types of repayment methods as follows

- **Maturity Loans –** The principal is repaid at the end of the loan and interest costs are based on the same outstanding balance throughout the life of the loan;

- **Equal Instalment of Principal (EIP) Loans –** The principal is repaid by equal instalments over the life of the loan, and the interest cost reduces over the life of the loans;

- **Annuity Loans –** The combined amount of principal and interest repaid on each payment date is constant throughout the life of the loan. With the principal increasing and the interest element reducing throughout the loan.

8. The annuity and EIP structures above have a shorter weighted life than maturity loans with the same final repayment date, as EIP and annuity loans contain a contractual obligation to make regular repayments of principal. While the interest rates offered by the PWLB may initially look lower for EIP and Annuity rates, this is due to the fact they have a shorter average life and is a reflection of the positively sloping yield curve. As all of the PWLB's fixed rates are derived from the same underlying gilt yield curve, there is little benefit in selecting one repayment method over another in terms of rate when considering the average life of debt.

9. As Epping Forest HRA surplus balances take a number of years to accrue to significant levels there is little scope for repayment of principal in the early years. As the Council would not want to replace maturing debt at higher PWLB margins, Arlingclose therefore recommend that maturity loans are used, as these do not contain any contractual obligation to repay debt in the early years.

Whether to use Fixed or Variable Rate

10. PWLB offers fixed rate loans on all three types of repayment methods, but only two for the variable rate loans, as it does not offer variable rate on Annuity loans.

11. Given the ultra low levels of fixed rates there is potentially only so much further they can fall, and with the reduced rate being offered for self-financing payment only, should interest rates deviate from the forecast (i.e. increase sooner than expected) it will make the cost of subsequently "fixing in" variable rate debt relatively expensive with rates reverting to 1% above gilts on all other days.

12. Arlingclose are not forecasting the bank rate to move above 0.5% before the end of 2015, therefore the Council have the opportunity to participate in lower debt cost (i.e. rates for self-financing are around 0.7% for variable rates, compared 2.5% for fixed) if rates stay low for longer. It also mitigates the risk inherent in fixing in loans at the wrong point of the curve or at the wrong time.

13. Arlingclose therefore recommend a portion of debt on variable rates of interest as an effective solution to the management of interest rate risk and makes sense from an

affordability and budgetary perspective as rates are expected to remain at very low levels in the early years of HRA self-financing.

The Length of Loans

14. PWLB offers loans between one and fifty years, with half yearly tenors also available. However, the maximum life of a variable rate loan is ten years for a Maturity and EIP loan. Fixed rate loans are available on all three types up to a maximum fifty years.

15. As mentioned previously the Council will not have spare surpluses to repay principal until later in the financial plan, and as any subsequent replacement of PWLB borrowing or debt restructuring, including replacing variable rate loans with fixed, will be undertaken at a significantly higher margin, there is an incentive for the Council to ensure certainty of rate and margin by selecting sufficiently long-dated debt in the first instance.

16. As the financial plan has been constructed to cover a 30 year period, most of the debt will be repaid towards the end of that period.

Portfolio Structure

17. Arlingclose have modelled two borrowing solutions based on the following portfolio structures:

- **Option 1** -. to borrow up to the Council's HRA CFR limit of £153.6m;
- **Option 2 –** to borrow the whole £185.5m and apportion debt by CFR.

18. Both of the options will have the majority of the debt on long dated fixed rate maturity ranging from twenty-six to thirty years, and a small proportion on ten year variable rate loans. The exact debt portfolio has yet to be confirmed, this will not be fully known until the 26 March 2012 when the interest rates are known. It is proposed that this will be agreed by the Finance & Economic Development Portfolio Holder in conjunction with advice from Arlingclose and the Director of Finance & ICT.

The Amount to Borrow

19. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This is a gauge for the Council's debt position. The Council currently does not have an overall positive CFR (HRA and Non-HRA), but following the payment to Government for Housing Self-financing, the Council will have a positive CFR as follows:

CFR	**Pre Self-financing £m**	**Post Self-financing £m**
General Fund	31.097	31.097
Housing Revenue Account	-31.881	153.575
Total CFR	**-0.784**	**184.672**

20. There are two options considered by Arlingclose, one that the Council borrows the whole £185.5m and the other option is to borrow up to the HRA CFR and use internal resources to fund the difference.

- **Borrow up to the HRA CFR**

21. If the Council was to borrow up to the HRA CFR, then it would borrow £153.6m from

PWLB and £31.9m would need to come from the Councils own internal resources, of which, the Council has around £50m available in investments. By the 28th March 2012, the Council can be in a position where it would have the necessary cash available to be used to fund this element.

22. Although the GF does not have the facility to finance the whole £31.9m, it can use £16.6m of its revenue and capital reserves. However, the impact of this would be as follows:

Balances to be used	£m	Impact
Revenue Reserves	3.9	This would leave the Council with the minimum 25% of reserves of Net Budget Requirement by the end of the Medium Term Financial Strategy 2015/16.
DDF	1.3	This would leave the DDF at nil by the end of the Medium Term Financial Strategy 2015/16.
Capital balances	11.4	This would leave the current Medium Term Capital Programme unfinanced on the General Fund past the current financial year (2011/12). Therefore, it would be necessary to either borrow to finance next year's capital programme or to review next year's capital programme and make amendments.
Total	**16.6**	

23. The HRA would then need to finance the remaining £15.3m. This would come from the HRA revenue balances, major repairs reserve, repairs fund and capital receipts. This would have an impact on the HRA financial plan that the Housing Portfolio Holder is proposing elsewhere on this agenda, where the further enhanced service is now being proposed.

24. This would still leave the GF with a CFR of £14.5m and the appropriate charge based on the average rate on interest earned on investment being made, in line with our treasury strategy, but this may be effected by CIPFA guidance on interest apportionment, which we are still awaiting.

25. This option has the following significant consequences that need to be carefully considered:

(a) Not prudent to run down balances at this time given uncertainty on future funding for the Council;

(b) Undesirable to build in a need for GF to borrow externally to finance capital programme at normal (higher) PWLB rates;

(c) Council left in situation where it may need to finance day-to-day cash flow with short-term borrowing.

26. It would be possible to fund a payment directly from the Council's cash resources, rather than specifying the use of particular reserves. However, this would leave a position where the resources were no longer cash backed and so any use of reserves for a given scheme would then need to be supplemented by borrowing at higher rates.

- **Borrow the whole amount and apportioned debt by CFR**

27. If the Council decided to borrow the whole £185.5m, then the HRA would finance £153.6m of the debt (up to their HRA CFR) and the GF would need to borrow £31.1m.

28. This option provides absolute equality between the funds, however, this has a detrimental impact on the GF, requiring the general fund to externalise its borrowing at a average rate of 3.45% compared to currently being charged around 1% based on the average rate of interest earned on investments. This would cost the GF an extra £760,000.

29. This option would not be recommended as this fails to reach the primary requirement of no detrimental impact on the general fund.

30. An alternative is for the HRA to fully fund the £185.5m and to use the additional borrowing to maintain flexibility in the HRA capital programme in relation to the enhanced programme that Cabinet are considering elsewhere on the agenda.

31. Then to charge the GF for its CFR based on the average interest earned on investments, as it currently does and is in line with our current treasury strategy. The HRA financial plan that the Housing Portfolio Holder is bringing to the same meeting, has budgeted, based on this scenario. This option has no detrimental impact on the GF and the HRA financial plan is fully funded and is now showing further enhancements on top of the enhancements already approved by Cabinet in December.

32. However, the Council is still establishing whether this scenario is permitted. Discussion with CLG earlier in the year indicated that CIPFA are developing guidance to give Council's the flexibility to set their own charges and thus this scenario would be entirely reasonable. However, we have still to receive final confirmation that this is valid and therefore Arlingclose are currently unable to recommend this solution to the Council.

33. The Council has again requested advice / guidance on our situation with CLG, CIPFA and our external auditors and an oral update on the night on the latest situation will be provided.

- **Borrowing over the HRA CFR but below the settlement figure**

34. The best solution for the GF in relation to no detrimental impact on the fund would be for the HRA to fully borrow the £185.5m and to continue to charge the GF based on its CFR of £31.1m on the average rate of interest earned on investment. However, as set out above this option may not be available to the Council.

35. Externalising the GF debt (£31.1m) using PWLB would provide absolute equality between the funds, but would have a major detrimental impact of the GF. Therefore, it may be required to have a half-way solution. Appendix 1 highlights a further two solutions along with providing financial analysis on the options already mentioned. The table below summarises the cost to each of the GF and HRA funds.

Cost to the fund	Option 1	Option 2a	Option 2b	Option 3	Option 4	Included within 2012/13 estimates
	£m	£m	£m	£m	£m	£m
HRA	4.755	5.130	5.892	5.148	5.148	5.787
GF	0.384	0.790	0.028	0.397	0.270	(-)0.011

36. The two new options look at the possibility of using capital receipts to forward fund our capital programme, thus reducing the GF CFR, but as and when the capital expenditure is applied this would increase the GF CFR and would eventually get back to the same level over a number of years.

37. The two options are summarised below:

	Option 3 - Use HRA balances & reduce GF CFR	**Option 4 - Use HRA & GF balances & reduce CFR**
Uses GF balances	£0m	£5.2m
Reduce CFR through using capital receipts	£11.4m	£11.4m
Cost of option	£0.4m	£0.3m
Advantages using this option	• This provides absolute equality between funds; • The Council will maintain its revenue balances as shown in the MTFS; • Reduce borrowing costs through the reduction in the CFR from the transferring of capital receipts to the Capital Adjustment Account	• This provides absolute equality between funds; • Reduce borrowing costs through the reduction in the CFR from the transferring of capital receipts to the Capital Adjustment Account.
Disadvantages using this option	• Although borrowing costs will increase each year, as and when capital expenditure is applied.	• Although borrowing costs will increase each year, as and when capital expenditure is applied. • The Council will maintain its 25% of Net Budget Requirement, but not over this. • The DDF reserve will be nil by the end of the MTFS in 2015/16.

Waiver of Call In

38. Due to the Cabinet meeting being so close to when the Council is required to submit its request for borrowing from the PWLB on 26 March 2012, it is necessary for the call in for this report to be waivered.

Resource Implications:

Within the 2012/13 estimates, the current estimated cost for the GF paying HRA is £525,000, although interest earned for the GF had been calculated as £536,000 to produce a net credit of £11,000

Legal and Governance Implications:

The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2009/10);
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the ODPM (now DCLG) has issued Investment Guidance to structure and regulate the Council's investment activities.
- Under section 21(1)AB of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8 November 2007.

Safer, Cleaner and Greener Implications:

None.

Consultation Undertaken:

The Council has been working closely with it's Treasury Advisors (Arlingclose), and are requesting guidance from CLG, CIPFA and District Auditors.

Background Papers:

None

Impact Assessments:

<u>Risk Management</u>
The Council are currently establishing whether there are concerns, (with CLG, CIPFA and External Auditors) if the Council continue to over finance on the HRA and for the GF to pay a charge to the HRA based on the investment rate rather than the borrowing rate. Early indications from CLG would suggest that the Council has the flexibility to set its own rate for internal borrowing between the two funds, but if CIPFA and / or External Auditors views are different and considers this not to be allowed, then the Council would need to consider either charging the GF on the borrowing rate or to repay debt back to PWLB, so that debt falls into line with the HRA CFR.

The risk in relation to repaying debt early and incurring penalties on this debt could be mitigated through repaying back variable rate first, or the Council may be in a position to repay fixed rate debt early, but the penalty incurred on repaying early would be reduced due to the initial rates being around 85 bases point below current rates.

Equality and Diversity

Did the initial assessment of the proposals contained in this report for relevance to the Council's general equality duties, reveal any potentially adverse equality implications?	No
Where equality implications were identified through the initial assessment process, has a formal Equality Impact Assessment been undertaken?	N/A

What equality implications were identified through the Equality Impact Assessment process?
N/A

How have the equality implications identified through the Equality Impact Assessment been addressed in this report in order to avoid discrimination against any particular group?
N/A