Epping Forest District Council
2011/12

Auditor's comment on options for self financing of the Housing Revenue Account (HRA)

Introduction

Our comments below are solely our initial observations on the recommended option that has been presented to us by the Council. Our comments are not necessarily comprehensive. Any decisions must be made by the Council solely on the basis of its own analysis. In making our observations we cannot fetter our discretion to be taken at the time of the audit of the financial statements of the Council.

Background

The amount that the Council will need to pay on 28 March 2012, for self financing purposes, is £185,456,000[1] as advised by the DCLG. The Council does not have sufficient resources to finance this payment and will need to borrow money to do so.

The limit on the amount of housing debt that Epping Forest DC can hold is £185,457,000[2].

We have been presented with documentation by the Council's Finance Department setting out possible options for treatment of borrowing in this respect.

Recommended option

The Finance Department's recommended option (referred to in the documentation provided as option 2b) can be summarised as set out below, and we have restricted our comments to this option. It is important to note that, in presenting our view on this option, we have used the figures provided by the Finance Department and for the purposes of this comment have assumed them to be materially correct. We have not conducted any audit in respect of the accuracy of the figures used.

1. The option recommended by the Finance Department is that the whole £185,456k is borrowed, from the PWLB, to finance the payment to the DCLG.
2. The new borrowing of £185,456k will be funded wholly by the HRA and, consequently, the HRA will bear the financing costs of the debt at the PWLB rate. For estimation purposes it has been assumed that the interest rate charged for the loan will be in the region of 3.5%.
3. The HRA will charge the General Fund at a notional interest rate (yet to be determined but included in the Council's option appraisal at 1% being the average rate of interest received on investments) for the amount of debt equivalent to the General Fund Capital Financing Requirement (CFR) as an internal loan to finance the capital requirements of the General Fund from what will be an 'overfunded' HRA CFR. The General Fund CFR will not be affected by the recommended option and will still show a £31m underlying General Fund indebtedness for capital purposes.
4. Overall, the change to the Council's CFR is as set out below:

CFR	Pre-settlement £000s	Post-settlement £000s
General Fund	31,097	31,097
HRA	(31,881)	153,575
Total	(784)	184,672

5. The impact of taking up the recommended option is:
    a. The HRA will bear the full amount of interest on the borrowing of £185,456k (estimated at £6,398k at an average rate of 3.5%) but this would be offset by interest charged to the General Fund (estimated at £311k at a notional interest rate of 1%, charged on the General Fund's CFR, based on the average interest that would be earned on investing those funds)

[1] The Housing Revenue Account Self-financing Determinations: The Settlement Payments Determination 2012 (CLG: February 2012) – Annex A
[2] The Housing Revenue Account Self-financing Determinations: Limits on Indebtedness Determination 2012 (CLG: February 2012) – Annex B

and by actual interest receivable from investment of HRA balances (estimated at £196k using an average investment interest rate of 1%). Total cost to the HRA is approximately £5,892k.

b. The General Fund will bear the 1% notional interest charge on its CFR (estimated at £311k as stated above) offset by actual interest receivable from investment of GF balances (estimated at £283k using an average investment interest rate of 1%). Total cost to the GF is approximately £28k.

Review of the guidance

The CIPFA guidance *The guide to housing self-financing (December 2011)* states in paragraph 12 that the *"[settlement] debt, due to the current fiscal constraints, is to be the limit (cap) on an authority's HRA borrowing"* and goes on to state that *"The government has kept reserve powers to reopen the settlement if there are major policy changes impacting on the valuation achieved"*.

This cap is enshrined in the Localism Act 2011 and responsibility for compliance with the cap rests with the authority's Section 151 Officer (paragraphs 15 and 18).

The Council's recommended option is compliant with the requirement for the total amount of borrowing to not exceed the settlement debt cap.

The CIPFA guidance sets out 4 further principles in respect of allocation of loans between the HRA and the General Fund (Appendix 2). They are set out below along with our comments:

1. *The underlying principle for the splitting of loans, at transition, must be that of no detriment to the General Fund.* – There are no existing loans at the transition date and so this principle is only relevant in so far as it relates to the splitting of the settlement debt at transition. The recommended option does not split the settlement debt between the GF and HRA, which is reasonable given that the settlement payment is for HRA purposes, but instead allocates the entire settlement debt to the HRA. This allocation is not detrimental to the GF. The recommended option does, however, assume that it is acceptable to borrow in excess of the HRA's post-settlement CFR (we understand, under the guidance's provisions for borrowing in advance of need) and on that basis continues with the current practice of charging the General Fund, at a notional interest rate linked to the rate earned on investments, for the HRA 'funding' the General Fund's CFR. The matter of over-funding the CFR has been considered separately later in this paper. However, should it be determined that the recommended option does comply with the guidance on over-funding/borrowing in advance of need, the intention to charge interest in this way appears reasonable. Furthermore, given that the charge would be calculated in the same way as that prior to settlement, it could be argued to have met this principle as the effect on the General Fund would not be detrimental in the context of historical practice.
2. *Local authorities are required to deliver a solution that is broadly equitable between the HRA and the General Fund.* – Whilst this principle is to be observed, we consider that it should be observed within the context of the first principle above i.e. that the solution must be equitable in so far as it can be without causing detriment to the General Fund. The Council's preferred option provides for the HRA to fund the entire debt, but it is internally charging the General Fund for the amount of debt relevant to the General Fund CFR. This could be argued to be equitable given that the General Fund will be sharing an element of the debt burden albeit at a lower notional interest rate than that likely to be charged on the external borrowing, with the lower interest rate charge allowing principle 1 above to be met. Charging the General Fund at the external borrowing rate could be said to be detrimental to it as this would be at a higher rate of interest than it has previously borne.
3. *Future charges to the HRA in relation to borrowing are not influenced by General Fund decisions, giving a greater degree of independence, certainty and control.* – This is an intended consequence of the Council's preferred option.
4. *Uninvested balance sheet resources which allow borrowing to be below the CFR are properly identified between General Fund and HRA.* – The Council's has stated their preferred option does not utilise any balance sheet resources to allow borrowing to be below the CFR so this principle would not apply.

However, notwithstanding the comments above, the following matters need, in our view, further consideration.

Over funding the HRA CFR

The Council has interpreted the guidance as being that any borrowing over and above the HRA's post-settlement CFR but below the settlement debt cap is allowable as 'over funded HRA CFR'. The guidance states:

> *"Where an authority, as a result of an identified need and in line with the their treasury management strategy for the HRA, borrows in advance of need, this will result in an overfunded HRACFR position which will result in cash in hand to be dealt with through the interest on balances calculation. Any permissible facility for borrowing in advance of need must be clearly stated in the treasury management strategy at the beginning of the year in accordance with the prudential framework."* (Appendix 2 p.89)
>
> This is also illustrated with example C in the table on page 82 of the guidance.

The guidance implies, therefore, that over funding of the HRA CFR is where there has been borrowing in advance of a need to borrow at a later date to fund **HRA** capital expenditure. If this is the case it would mean that the Council will need to clearly demonstrate that this is the case and that there is an identified future need for the additional HRA borrowing of £31,881,000 (the amount of over funding that will be used to cover the internal funding of the General Fund's needs).

We have not had access to the final HRA Business Plan when constructing this paper but the Treasury Management Strategy Statement (TMSS) shows that HRA capital expenditure is estimated to be in the region of £43m over 2012/13 to 2014/15 (Table at 3.1 of the TMSS) although no increase is projected in the HRA CFR over the same period (Table at 5.1 of the TMSS) and other than the settlement borrowing, the financing table at 3.2 of the TMSS shows that capital expenditure will be funded from internal resources, without the need for any external borrowing in the medium term.

This raises the question of whether there is an identified need for borrowing in the future to fund the HRA's capital requirements. Currently it appears that the Council's future borrowing need is primarily, if not solely, for the purpose of funding General Fund capital expenditure and that this future HRA borrowing need is not fully evidenced. We would need to review the TMSS capital expenditure estimates against the final approved HRA Business Plan to ensure that the TMSS accurately reflects the Council's intended capital investment in its housing stock, before we could form a view on the Council's position in this respect.

Determining a fair rate of interest

Setting aside the outstanding considerations above, should it be concluded that the recommended option is viable, supportable and compliant with the guidance, the question of whether it is appropriate to continue to charge the internal borrowing by the General Fund at the average rate of interest earned on investments or whether another rate of interest would be more appropriate or equitable becomes relevant.

The Finance Department are currently seeking further guidance from the DCLG in this respect whose initial response has been that the Treasury Management Code continues to apply in that councils should *"choose and evidence a fair rate of interest to charge"* and that they expect further clarity in a future CIPFA LAAP Bulletin.

If the recommended option is taken forward then it could be argued that it is, in fact, more equitable (under the second of the four principles referred to earlier) for the GF to be charged at an interest rate that is closer or equal to the external borrowing interest rate that would be charged on the settlement loan. This would more accurately reflect the underlying need for the borrowing if it were determined that it is a GF not HRA need. However, the Finance Department argue that this would be detrimental to the GF at the point of transition because it would result in an elevated charge to that previously borne by the GF for internal borrowing. This is a reasonable argument that supports the assertion that the average rate of return from investments would be a fair rate of interest to charge.

Further guidance on interest charges and how the settlement is to be accounted for within the HRA and the Council's accounts is still being considered by CIPFA and DCLG. A LAAP Bulletin is anticipated that will provide guidance to practitioners. This was expected in January 2012 (as referred to in Appendix 3 of the CIPFA guidance) but has yet to be issued.

Compliance with the Prudential Code indicators for prudence

Lastly, we have considered the Council's compliance with the Prudential Code's indicators for prudence. The Prudential Code states that:

> *"In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. If in any of these years there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with net external borrowing. This is a key indicator of prudence. This prudential indicator will be referred to as net borrowing and the capital financing requirement. Where there is a significant difference between the net and the gross borrowing position the risks and benefits associated with this strategy should be clearly stated in the annual strategy."* (paragraph 43)

Applying this definition, the Council's net borrowing and the capital financing requirement indicator would be:

	£000s
Preceding year CFR	(784)
Estimated increase in CFR for the current year	185,456
Estimated increase in CFR for 2012/13	0
Estimated increase in CFR for 2013/14	0
Net borrowing and capital financing requirement	**184,672**

If the Council were to borrow to fund the full £185,456k this could be said to breach this key indicator of prudence by £784,000 which will need to be fully justified in the TMSS.