REPORT FOR: **GOVERNANCE, AUDIT, RISK MANAGEMENT AND STANDARDS COMMITTEE**

Date of Meeting:	8 September 2016
Subject:	**Information Report -** Treasury Management - Prudential Indicators
Responsible Officer:	Dawn Calvert, Director of Finance
Exempt:	No
Wards affected:	All
Enclosures:	None

Section 1 – Summary

At the request of the Committee at their meeting on 19 July, this report expands on information previously provided in respect of borrowing, the capital programme and prudential indicators and invites the Committee's consideration.

FOR INFORMATION

Section 2 – Report

Introduction

1. At their meeting on 19 July 2016 the Committee considered two reports concerning the Council's Treasury Management activities:
    - Reference from Cabinet (16 June 2016) – Treasury Management Outturn 2015-16
    - Treasury Management Responsibilities and the Interpretation of Treasury Management Reports

2. Members raised a number of issues in relation to these reports including:

- The Council's borrowing limit
- The Council's borrowing at the time of the abolition of the HRA subsidy system
- Appropriateness of prudential indicators
- Funding for regeneration programme

3. These matters are considered in sections A-D below.

A. The Council's borrowing limit

<u>Legislation and Regulation</u>

4. The Council's power to borrow is established under the Local Government Act 2003 the relevant clauses of which are as follows:

   1. <u>Power to borrow</u>

   A local authority may borrow money-
   (a) for any purpose relevant to its functions under any enactment, or
   (b) for the purposes of the prudent management of its financial affairs

   2. <u>Control of borrowing</u>

   (1) A local authority may not borrow money if doing so would result in a breach of –
   (a) The limit for the time being determined by or for it under section 3, or
   (b) Any limit being applicable to it under section 4.

   3. <u>Duty to determine affordable borrowing limit</u>

   (1) A local authority shall determine and keep under review how much money it can afford to borrow

   4. <u>Imposition of borrowing limits</u>

   (1) The Secretary of State may for national economic reasons by regulations set limits in relation to the borrowing of money by local authorities.
   (2) *The Secretary of State may by direction set limits in relation to the borrowing of money by a particular local authority for the purpose of ensuring that the authority does not borrow more than it can afford.*

5. The Secretary of State has not used his powers either in the national context nor, specifically, in relation to Harrow. The controls on the

Council's level of borrowing are, therefore, only those arising from clauses 1-3 of the Act and subsequent regulation.

6. Whilst the legislation imposes a broad duty for the Council to determine and keep under review the amount it can afford to borrow, the Secretary of State has subsequently defined this duty in more detail through the Prudential Code produced by CIPFA, which lays down the practical rules for deciding whether borrowing is affordable.

7. It is for the Council (at a meeting of the full Council) to set its own 'prudential' limit in accordance with these rules, subject only to the scrutiny of its external auditor. The Council is then free to borrow up to that limit without Government consent. The Council is free to vary the limit during the year, if there is good reason.

8. Requirements in other legislation for the Council to balance its revenue budget prevent the long-term financing of revenue expenditure by borrowing.

Harrow Policy

9. The Council sets its borrowing limit (known as the Authorised Limit for External Debt) in February of each year as part of its approval of the Treasury Management Strategy Statement.

10. The limit is set at the same level as the Capital Financing Requirement which represents the Council's underlying need to borrow to finance historic and estimated future capital expenditure. It comprises the funding requirement for capital expenditure not met by other sources of funding plus additional leasing liabilities, less monies set aside for the repayment of debt, largely through the Minimum Revenue Provision.

11. Below is the Capital Financing Requirement (CFR) advised to Council at their meeting on 18 February 2016. The CFR is a cumulative figure usually increasing to reflect the capital programme for each year less non-borrowing sources of funding and the annual MRP.

Table 1 Capital Financing Requirement

	2015/16	2016/17	2017/18	2018/19
	Estimate	**Estimate**	**Estimate**	**Estimate**
	£'000	**£'000**	**£'000**	**£'000**
CFR as at 31 March				
Non – HRA	286,943	356,142	396,779	401,829
HRA	151,213	154,783	154,753	154,723
TOTAL	**438,156**	**510,925**	**551,532**	**556,552**
Annual change in CFR				
Capital expenditure	116,967	133,455	92,270	49,070
Non-borrowing sources of funding	- 72,831	- 47,709	- 37,153	- 28,622
Lease liability	500	389	410	456
Less MRP	- 12,377	- 13,365	- 14,920	- 15,884
TOTAL	**32,259**	**72,769**	**40,607**	**5,020**

12. Based on the above Capital Financing Requirement the Council agreed authorised limits for borrowing as follows:

2016-17	£511m
2017-18	£552m
2018-19	£557m

13. Theoretically the Council can increase its Capital Financing Requirement and authorised limit without limit so long as it is set for capital expenditure purposes and the Council considers it to be prudent and affordable.

14. At their meeting on 19 July the Committee asked specifically about the impact of the Council's regeneration programme on the Council's ability to borrow. The programme in the table above assumed expenditure on regeneration of £16.2m in 2016-17 and £14.2m in 2017-18 mainly to cover the Wealdstone site assembly, the Gayton Road development and the Haslam House redevelopment. The programme has since been developed further and the latest estimated borrowing requirements are:

	£m	
2016-17	16.6	(includes £16.2m as above)
2017-18	83.8	(includes £14.2m as above)
2018-19	114.4	
2019-20	110.2	
2020-21	27.2	
2021-22	4.5	

15. These revised figures will be included in the mid-year monitoring report in November and the Council will be asked to revise the authorised borrowing limits accordingly.

16. Borrowing at these levels is in accordance with the legislation and regulations so long as:
    - It is used to fund the capital programme as described
    - It is considered by the Council to be affordable

17. The matter of affordability is considered in Section C below.

18. Within her overall responsibility for the administration of the financial affairs of the Council the Director of Finance has delegated authority to approve all new borrowing but will only act in accordance with approved policy and having taken advice from the Council's treasury management adviser.

B. The Council's borrowing at the time of the abolition of the HRA subsidy system

19. On 15 December 2011 Cabinet considered a report entitled "Housing Reform and Housing Revenue Account Budget Setting 2012-13 to 2016-17." So far as Treasury Management was concerned the most significant element in the reform was the assumption of full control of the HRA by the Council and the abolition of housing subsidy. The main condition for the Council attaching to this reform was the payment of £89m to the Government. This settlement sum had been calculated by the

Government based on projections of the income and expenditure assumptions used to calculate HRA subsidy over a thirty year period.

20. On 9 February 2012 Cabinet considered the annual Treasury Management Strategy Statement which made reference to the HRA reforms as follows:

> *41. Harrow currently pays the Government £7.0 million p.a. under the HRA subsidy system. The Government is abolishing these arrangements in exchange for a one off payment by Harrow estimated at £89.0 million on 28th March 2012. The payment to the government could be funded from existing cash balances or new external borrowing. It is intended to fully fund the payment using PWLB debt to take advantage of the low cost funds available. Not only are gilt yields at post war lows but the margin over gilt yields charged on PWLB borrowing for settlement purposes has been reduced from the standard 1% to 0.15%, a saving of 0.85% p.a. Current cash balances are required to cover debt maturities and net capital expenditure in the next 2-7 years. Other sources of debt have been investigated, but are more expensive than the PWLB. Funding using LOBO structures was considered to be excessively risky with interest rates expected to increase significantly in future.*
>
> *42. Short term savings could be made by funding some or all of the settlement payment through short term (10 year) debt rather than longer term (50 year) debt and refinancing the settlement debt in 2022. Interest costs are expected to increase steeply such that over a 50 year period the additional interest cost from taking 10 year debt initially and refinancing is £65 million. Although the HRA business plan anticipates revenue surpluses from year 10 onwards, this may be used to support new capital spend and will not necessarily be available to repay debt. Using debt maturities between 20 & 40 years also leads to additional costs compared to 50 year debt.*
>
> *43. The sharing of the cost of debt between the General Fund and the HRA is an important decision for the Council. Councils have freedom to develop their own approach provided it is (1) fair to both the GF and HRA, and (2) is approved by full Council. Two approaches have emerged – one pool and two pools. One pool involves combining all existing and new debt and allocating a proportion to HRA based on its capital balance. The two pool approach is to allocate HRA a share of existing debt based on pre settlement capital together with all the new debt acquired for settlement purposes.*
>
> *44. A single debt pool is preferred as it will maximise flexibility ensuring that HRA is only charged for the level of capital it holds. There is then no risk of the HRA being over or under borrowed. Also it enables debt to be switched to the GF if HRA generates surplus, which will support the repayment of existing debt.*
>
> *45. The HRA's maximum level of debt as measured by its capital finance requirement under the new self financing arrangements will*

equal the CFR of the HRA as at 31st March 2012, projected at £152.2 million.

21. In accordance with the policy described above, on 28 March 2012 an advance was taken from PWLB in the sum of £88.461m for a period of 50 years at an annual interest rate of 3.48% (£3.078m pa). At the time this loan was taken it was at the most beneficial rate of any of the Council's existing loans and that remains the position today.

22. As considered below, the Prudential Indicator requirement deemed most relevant to the affordability of new debt is the ratio of financing costs to net revenue stream and this played a part in the consideration of the HRA self-funding borrowing.

23. The Treasury Management Strategy Statement for 2012-13 estimated the impact of the HRA reform and indicated that the financing costs would increase from 25% in 2010-11 to 53 % in 2012-13 (actual 46.1%). However, it was also recognised that had the subsidy payment made by the Council to the national pool over previous years been treated as a capital cost the increase would have been minimal. Hence, whilst the borrowing costs increased significantly, this was largely offset by a reduction in "fixed" revenue costs. The history of the ratio to date in the "Prudential Indicator" format has been as follows:

Table 2 Prudential Indicator – financing costs against net revenue stream (historic)

	2011/12	2012/13	2013/14	2014/15	2015/16
Net revenue stream (£'000)	27,635	29,155	31,509	31,926	32,141
Interest costs of self-funding borrowing (£'000)	0	3,078	3,078	3,078	3,078
Interest costs of other borrowing (£'000)	2,357	3,355	3,356	3,265	3,265
Interest and investment income (£'000)	(84)	(101)	(63)	(50)	(60)
Depreciation (£'000)	4,173	6,629	7,309	7,338	7,784
Impairment (£'000)	1,503	490	282	1,765	172
Total financing costs (£'000)	7,949	13,451	13,962	15,396	14,239
Ratio of total financing costs against net revenue stream (%)	28.8	46.1	44.3	48.2	44.3
Ratio of total financing costs (excluding depreciation and impairment) against net revenue stream (%)	8.2	21.7	20.2	19.7	19.5

Table 3 Prudential Indicator – financing costs against net revenue stream (ongoing)

	2016/17	2017/18	2018/19	2019/20
Net revenue stream (£'000)	32.170	32.250	31.981	31.836
Interest costs of self-funding borrowing (£'000)	3.078	3.078	3.078	3.078
Interest costs of other borrowing (£'000)	3.316	3.391	3.389	3.388
Interest and investment income (£'000)	(52)	(29)	(41)	(14)
Depreciation (£'000)	6.573	7.619	7.618	7.590
Impairment (£'000)	0	0	0	0
Total financing costs (£'000)	12.915	14.059	14.044	14.042
Ratio of total financing costs against net revenue stream (%)	40.1	43.6	43.9	44.1
Ratio of total financing costs (excluding depreciation and impairment) against net revenue stream (%)	19.7	20.0	20.1	20.3

24. The Council is not required to take into account comparative statistics from other authorities nor performance indicators since each authority has its own unique circumstances reflecting its history and local circumstances. It should, however, take into account movements over time and the reasons for this and the effect its financing costs have on other parts of its budget. Since 2012-13 both the ratios calculated above have remained reasonably stable with the ratio of total financing costs against net revenue stream ranging from 40.1% to 48.2% and the ratio of total financing costs excluding depreciation and impairment to net revenue stream ranging from 19.5% to 21.7%.

25. Cabinet and the Committee are usually given only one row of figures in respect of this indicator, the ratio of total financing costs against net revenue stream. If the Committee wish, the details as shown above can be provided which will, perhaps give them a better understanding of the indicator.

C. Appropriateness of prudential indicators

26. Under the Prudential Code for Capital Finance in Local Authorities (CIPFA 2013) the Council is required to consider:

- Ratio of Financing Costs to Revenue Stream for General Fund and HRA
- Incremental impact of General Fund capital investment decisions on Band D Council Tax levels
- Incremental impact of HRA capital investment decisions on weekly housing rents

27. These indicators are considered by CIPFA and the Government to be the most suitable measures of affordability and of external borrowing and other long term liabilities being within prudent and sustainable levels.

28. In addition the Council, along with many other authorities, reports on additional HRA indicators as follows:

29. Officers are not aware of any authority reporting on any other indicators as part of the Treasury Management reporting process. It is therefore assumed that these indicators are generally accepted as the most appropriate measures of affordability and sustainability.

30. The Cabinet and Committee have seen the indicators on many occasions and have received detailed explanations as to their rationale. However, they have not necessarily seen a detailed breakdown of the indicators which could lead to a better understanding of their value.

Ratio of Financing Costs to Revenue Stream for General Fund

31. Below is a table used for the Treasury Management Strategy Statement 2016-17 which shows the impact of the General Fund capital programme in the context of a reducing net revenue stream.

Table 4 Ratio of Financing Costs to Revenue Stream for General Fund

	2015/16	2016/17	2017/18	2018/19
Net revenue stream (£'000)	167,133	165,754	155,696	145,563
Interest costs (£'000)	7,797	8,378	9,412	11,088
Interest costs - finance leases (£'000)	2,100	2,100	2,100	2,100
Interest and investment income (£'000)	-1,699	-1,509	-1,476	-1,656
MRP (£'000)	14,000	13,000	13,000	13,000
Total Financing costs	22,198	21,969	23,036	24,532
Ratio of total financing costs against net revenue stream (%)	13.3	13.3	14.8	16.9

32. The Council is not required to take into account comparative statistics from other authorities nor performance indicators since each authority has its own unique circumstances reflecting its history and local circumstances. It should, however, take into account movements over time and the reasons for this and the effect its financing costs have on other parts of its budget.

Ratio of Financing Costs to Revenue Stream for HRA

33. See paragraphs 23-25 above

Incremental Impact of Capital Investment Decisions – Band D Council Tax

34. This indicator identifies the revenue costs associated with the capital programme and the impact on Council Tax charges.

35. It represents total debt charges ie interest and Minimum Revenue Provision of all General Fund incremental borrowing, dividing the result by the tax base for Council Tax and expressing this as an annual increase in Council Tax for a Band D property.

36. For the sake of realism, the table below is based on information reported recently to both Cabinet and the Committee. Whilst a number of the figures are indicative only they provide the Committee with the methodology behind the Indicator and a feel for the impact of their decisions.

Table 5 Incremental Impact of Capital Investment Decisions – Band D Council Tax

	2014-15	2015-16	2016-17	2017-18	2018-19
Net financing need (£'000)	28,325	28,601	85,746	55,117	20,448
Borrowing at 2.0% (25-50 years PWLB rate) (£'000)	567	572	1,715	1,102	409
MRP (2%) (£'000)	567	572	1,715	1,102	409
Total increased costs (£'000)	1,134	1,144	3,430	2,204	818
CTax base £'000)	78,550	79,795	80,000	80,000	80,000
% increase	1.4	1.4	4.3	2.8	1.0
Band D Council Tax	1,210	1,234	1,240	1,240	1,240
Overall increase £ pa	16.94	17.28	53.32	34.72	12.40

37. The Council is not required to take into account comparative statistics from other authorities nor performance indicators since each authority has its own unique circumstances reflecting its history and local circumstances. Nevertheless, this indicator is a measure of the impact of specific capital spending decisions on taxpayers. However, since Council Tax is set in the context of many spending demands and savings and legislative requirements this impact will not be obviously identifiable in bills.

Incremental Impact of Capital Investment Decisions – Average weekly housing rent

38. This indicator identifies the revenue costs associated with proposed capital programme and the impact on Housing Rents.

39. It represents total depreciation expressing this as an increase in the average weekly housing rent. The forecast for HRA dwelling depreciation

was based on valuations as they stood at the date of the forecast. However the Council has no real ability to control the depreciation calculation following the end of the transitional period for the introduction of component accounting.

Table 6 Incremental Impact of Capital Investment Decisions (Depreciation methodology) – Average weekly housing rent

	2015/16	2016/17	2017/18	2018/19
	Estimate	Estimate	Estimate	Estimate
	£	£	£	£
Current Year Depreciation	6,906,350	6,573,479	7,619,202	7,617,663
Prior Year Depreciation	7,338,000	6,906,350	6,573,479	7,619,202
Net movement	-431,650	-332,871	1,045,723	-1,539
No of Dwellings	4,867	4,816	4,860	4,845
Increase in average housing rent per week	- 1.71	- 1.33	4.14	- 0.01

40. The above table is not an entirely satisfactory indicator due to the fluctuations in depreciation calculations particularly due to the effect of transitional relief available in 2015/16 and 2016/17, but no longer available from 2017/18.

41. An alternative method of viewing the incremental impact of capital investment decisions on housing rents is shown in the table below but the fact that the Council is only expecting to borrow a small amount in one year tends to undermine its value.

Table 7 Incremental Impact of Capital Investment Decisions (Net financing need methodology) – Average weekly housing rent

	2015/16	2016/17	2017/18	2018/19
	Estimate	Estimate	Estimate	Estimate
Net Financing need (£'000)	-	3,570	-	-
Borrowing @ 2% (25-50years PWLB rate) (£'000)	-	71	-	-
Depreciation @ 2% (£'000)	-	71	-	-
Total increased costs	-	143	-	-
Number of dwellings	4,867	4,816	4,860	4,845
Increase in average housing rent per week £	**-**	**0.57**	**-**	**-**

42. The Council is not required to take into account comparative statistics from other authorities nor performance indicators since each authority has its own unique circumstances reflecting its history and local circumstances. Nevertheless, over the long term this indicator has been seen as a measure of the impact of specific capital spending decisions on housing tenants. However the current four-year rent reduction imposed by the Welfare Reform and Work Act 2016 has effectively removed any discretion local authorities previously had in respect of rent setting.

Discretionary HRA Indicators

43. Both of the indicators in the table below are self-explanatory and are potentially valuable as long term indicators of prudence and affordability.

Table 8 Discretionary HRA Indicators

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	2015/16	2016/17	2017/18	2018/19
	Estimate	Estimate	Estimate	Estimate
Debt (CFR) (£m)	151.2	154.8	154.8	154.7
Gross Revenue Stream (£m)	32.2	32.2	32.3	32.0
Ratio of Gross Revenue Stream to Debt (%)	**21**	**21**	**21**	**21**
Average Number of Dwellings	4,867	4,816	4,860	4,845
Debt outstanding per dwelling (£)	**31,069**	**32,143**	**31,846**	**31,935**

D. Funding for regeneration programme

44. The table below shows the impact on the CFR and authorised borrowing limit of the inclusion of the Regeneration programme as follows:

	£m	
2016-17	16.6	(£16.2m already included)
2017-18	83.8	(£14.2m already included)
2018-19	114.4	

Table 9 Capital Financing Requirement including Regeneration Programme

	2015/16	2016/17	2017/18	2018/19
	Estimate	Estimate	Estimate	Estimate
	£'000	£'000	£'000	£'000
CFR as at 31 March				
Non – HRA	286,943	339,967	366,354	371,404
HRA	151,213	154,783	154,753	154,723
Regeneration		16,655	100,425	214,875
TOTAL	**438,156**	**511,405**	**621,532**	**741,002**
Annual change in CFR				
Capital expenditure	116,967	133,934	161,790	163,520
Non-borrowing sources of funding	- 72,831	- 47,709	- 37,153	- 28,622
Lease liability	500	389	410	456
Less MRP	- 12,377	- 13,365	- 14,920	- 15,884
TOTAL	**32,259**	**73,249**	**110,127**	**119,470**

45. As considered earlier in the report there is no legal constraint on increasing the CFR and authorised borrowing limits to reflect capital expenditure but the Council must be satisfied that the revenue costs arising are affordable.

46. The following two tables help the Council to consider the affordability as they compare the ratio of financing costs before and after the inclusion of the Regeneration Programme.

Table 10 Ratio of total financing costs against net revenue stream (excluding Regeneration Programme)

	2015/16	2016/17	2017/18	2018/19
Net revenue stream (£'000)	167,133	165,754	155,696	145,563
Interest costs (£'000)	7,797	8,378	9,412	11,088
Interest costs - finance leases (£'000)	2,100	2,100	2,100	2,100
Interest and investment income (£'000)	-1,699	-1,509	-1,476	-1,656
MRP (£'000)	14,000	13,000	13,000	13,000
Total Financing costs	22,198	21,969	23,036	24,532
Ratio of total financing costs against net revenue stream (%)	13.3	13.3	14.8	16.9

Table 11 Ratio of total financing costs against net revenue stream (including Regeneration Programme)

	2015/16	2016/17	2017/18	2018/19
Net revenue stream (£'000)	167,133	165,754	156,178	149,139
Interest costs (£'000)	7,797	8,615	11,193	15,916
Interest costs - finance leases (£'000)	2,100	2,100	2,100	2,100
Interest and investment income (£'000)	-1,699	-1,509	-1,476	-1,656
MRP (£'000)	14,000	13,000	13,000	13,127
Total Financing costs	22,198	22,206	24,817	29,487
Ratio of total financing costs against net revenue stream (%)	13.3	13.4	15.9	19.8

47. The Regeneration Programme assumes capital receipts as follows:

£m	
2019-20	35.0
2020-21	38.4
2021-22	36.6

48. These receipts could enable some of the borrowing to be made short term and repaid on maturity which would have the effect of reducing the costs to the Council and the financing costs ratio.

FINANCIAL IMPLICATIONS

49**.** Whilst this report clearly deals with significant financial matters there are no financial implications arising directly from it

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RISK MANAGEMENT IMPLICATIONS

50**.** Whilst this report clearly deals with matters involving significant risk there are no risk management implications arising directly from it.

51. Risks are included in the Directorate Risk Register.

EQUALITIES IMPLICATIONS

52. Officers have considered possible equalities impact and consider that there is no adverse equalities impact as there is no direct impact on individuals

COUNCIL PRIORITIES

53. This report deals with matters which are fundamental to the Councils priorities but there are no implications arising directly from it.

Section 3 - Statutory Officer Clearance

Name: Dawn Calvert	X	Director of Finance
Date: 24 August 2016		

Ward Councillors notified:	**No**
EqIA carried out:	**No**
EqIA cleared by:	**N/A**

Section 4 - Contact Details and Background Papers

Contact: Ian Talbot (Treasury and Pension Fund Manager) Tel: 020-8424-1450 / Email: ian.talbot@harrow.gov.uk

Background Papers: N/A