PART II Borrowing and Investing

A key activity is to know when and how much to borrow when the Council requires more cash, and investing when the Council has surplus cash. In this way, it manages the Council's cashflows. This activity is known as treasury management.

1. Borrowing and Investing

1.1 Borrowing

The principle source of borrowing comes from the Public Works Loan Board, (PWLB) which is operated by HM Treasury. The PWLB offers a range of loan durations and principal repayment methods to Local Authorities. The PWLB represents a competitive source of borrowing for the Council.

This Capital Strategy identifies capital aspirations that may be included in future capital programmes. Prior to any borrowing, a full business case and financial appraisal is prepared that can satisfactorily demonstrate with good certainty that cost savings / additional income or value uplift of the development which will accrue directly the Council, will at least cover the cost of that borrowing on a sustained basis over the lifetime of the borrowing undertaken.

Outstanding long-term debt is reviewed regularly with a view to early redemption and rescheduling; as premiums would be payable to the lender, early redemption and rescheduling are rarely financially beneficial to the Council.

1.2 Affordability of Borrowing

In order to ensure future budgets remain affordable, with the exception of debt repaid using capital receipts, the Council needs to be aware that capital expenditure financed from prudential borrowing incurs both **interest costs** and a **Minimum Revenue Provision (MRP)** for the repayment of debt.

Interest Costs

Following the decision by the PWLB on 9 October 2019 to increase their margin over gilt yields by 100 bps to 180 basis points on loans lent to local authorities, consideration will also need to be given to sourcing funding at cheaper rates from the following:

- Local authorities (primarily shorter dated maturities)
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates)
- Municipal Bonds Agency (limited issuance at present but there is potential)

The degree to which any of these options proves cheaper than PWLB Certainty Rate, is still evolving at the time of writing, but future borrowing is likely to be at a higher margin over gilts than previous borrowing.

The Council has a policy of calculating MRP on an annuity basis. This means that MRP will start at a relatively low level but require increasing amounts of MRP to be set aside year on year, especially for assets with long useful economic lives. This creates a period of relatively low MRP during the early years when either income can be generated or savings can accrue.

Based on existing schemes, it is estimated that the MRP will increase to the following amounts in the short-term.

2020/21	£4.2m
2021/22	£4.0m

£2.0m of the increase in 2020/21 is due to MRP on the acquisition of Lakeside, North Harbour Business Park in 2019/20. £3.0m of the increase in 2021/22 is due to MRP being made again on the Housing Revenue Account (HRA) self-financing payment to the Government of £88.6m. MRP on the HRA self-financing payment had been suspended following the Government's requirement to reduce council dwelling rents.

The inclusion of further schemes in the capital programme financed by prudential borrowing will further increase the MRP.

1.3 Key Risks

There are risks with borrowing more than the Council can afford. In order to mitigate these risks, the **Chartered Institute of Public Finance and Accountancy (CIPFA)** has produced the **Prudential Code** for Capital Finance in Local Authorities, which is a statutory code governing local authority borrowing. The Prudential Code requires the Council to establish various indicators over a minimum of 3 years to demonstrate that its capital programme is both affordable and prudent. The Council publishes its **Prudential Indicators**, over a 5 year period, within its capital programme and the Council then reports its position against the prudential indicators at the end of each financial year.

In order to ensure that the borrowing required to finance the capital programme is affordable, the Council:

- estimates the ratio of its financing costs to its net revenue stream

In order to ensure that the Council's capital programme is prudent, the Council:

- publishes a capital programme which includes estimates of its underlying need to borrow as measured by its capital financing requirement
- is required to approve an **Authorised Limit** for external debt and an **Operational Boundary** when it approves its capital programme.

The **Authorised Limit** for external debt, as set by the City Council, is the maximum amount of debt which the authority may legally have outstanding at any time. The authorised limit includes headroom to enable the Council to undertake borrowing to take advantage of unexpected movements in interest rates and to accommodate any short-term debt or unusual cash movements that could arise during the year

Whilst the **Authorised Limit** cannot be breached, the **Operational Boundary** is based on the probable external debt during the course of the year. It is not a limit, but acts as a warning mechanism to prevent the authorised limit (above) being breached.

1.4 Sensitivity Analysis

The Council's gross debt at 31 March 2019 was as follows:

Table A	£m	£m
Fixed Rate Borrowing	509	
Finance Leases	1	
Private Finance Initiative (PFI) Schemes	65	
Sub Total - Fixed Rate Debt		575
Lenders Option Borrowers Option (LOBO) Loan	11	
Retail Price Index (RPI) linked loan	69	
Sub Total - Variable Rate Debt		80
Total Gross Borrowing		**655**

- 88% of the Council's borrowing has a fixed interest rate, but the Council does have two variable rate loans.
- The lender of the LOBO loan has an option to increase the interest rate every two years. The lenders next option is on 19 March 2021. If the lender does increase the interest rate the Council then has the option to repay the loan.
- The Council has £69m outstanding on a loan which links the instalments payable by the Council to the RPI. The Council has leased the Isle of Wight Ferry Terminal in White Heart Road to Wightlink on an RPI linked rent that mirrors the instalments payable on this loan mitigating the consequences of increases in RPI.

1.5 Minimum Revenue Provision (MRP) for Debt Repayment

Early in 2018 the Government issued revised statutory guidance on MRP requiring the repayment of all General Fund prudential borrowing to be provided for within 50 years.

The following MRP policies (applied to calculating the MRP) are set out in the table below and are fully compliant with this policy. It is recommended the City Council approves the Annual Minimum Revenue Provision (MRP) for Debt Repayment Policies set out in the table below (Recommendation 3.2a).

Borrowing	MRP Methodology
General Fund Borrowing:	
Supported borrowing other than finance leases and service concessions including private finance initiative schemes #	50 year annuity
Finance leases and service concessions including private finance initiative schemes *	MRP equals the principal repayments made to lessors and PFI operators
Prudential borrowing excluding borrowing to fund long term debtors (including finance leases), investment properties and equity shares purchased in pursuit of policy objectives	Annuity over life of asset
Prudential borrowing to fund long term debtors	The repayments of principal are set aside to repay the borrowing that financed the original advance
Prudential borrowing to fund finance leases	The principal element of the rent receivable be set aside to repay the borrowing that financed these assets
Prudential borrowing to fund investment properties	MRP will be provided where the current market value falls below the unfinanced capital cost of property. MRP will be determined by charging the unfinanced capital cost over the remainder holding period of the relevant asset. This being equal to the principal repayment on an annuity with an annual interest rate equal to the PWLB rate at start of financial year when MRP is charged. Upon sale of relevant asset the capital receipt received will be used to repay outstanding debt cost, where there is an unfinanced capital cost upon sale MRP will be charged for the difference.
Prudential borrowing to fund investment properties with an expected holding period of over 50 years	Annuity over life of asset
Prudential borrowing to fund equity shares purchased in pursuit of policy objectives	25 year annuity
Housing Revenue Account (HRA)	No MRP debt will be provided in 2020 / 21. From 2021/22 it will be provided again for the HRA Self Financing Payment in equal instalments over 30 years. MRP is not provided for other HRA debt.

 # The Council applied the last of its supported borrowing 2011/12

** If transactions that take the legal form of finance leases but in substance amount to borrowing, the MRP policy relating to self - financed borrowing will be adopted. An example of when this could happen would be when the Council grants a head lease to an institution in return for an upfront premium and leases the asset back from the same institution in return for a rent.*

The Council had a review of its MRP policy in 2016/17. As a consequence, it highlighted that the previous methods used in the past have resulted in over provisions of MRP from 2008/09 to 2015/16 of £22.6m. The Director of Finance and Resources (Section 151 Officer) will release the over provision of MRP back into General Fund balances over a prudent period by reducing the MRP in future years under delegated authority. The Director of Finance and Resources (Section 151 Officer) reduced the MRP by £1.9m in 2018/19. At this rate of release, the Council's MRP will be reduced for a further 9 years. It is not considered prudent to release the over provision of MRP back into the General Fund balances in a single year.

1.6 Timing of Borrowing

When the Council has surplus cash, this can be used to fund capital expenditure financed by borrowing in the short to medium term. This will result in a reduction in interest earned through the investment of surplus cash, but this can be more cost effective than borrowing the required funds straight away, as investment earned on investments is often less than the interest on borrowing. At some point in the future there will no longer be surplus cash and borrowing will have to be undertaken. In deciding when to borrow externally, forecast changes to interest rates will be taken into account.

If surplus cash is not used to fund capital expenditure in the short to medium term, it will be invested. A principle function of Treasury Management is to decide when the optimum time to take the borrowing is or whether to use surplus cash. A key decision is when to take the long term borrowing to fund previous decisions made about the capital programme. The Council may use surplus cash to fund the capital programme in the short-term.

The Council can therefore calculate a net loans requirement which represents a neutral treasury management position. This is summarised in the table below.

Table B	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2029/30
	£m	£m	£m	£m	£m	£m	£m	£m
1.Underlying need to borrow (CFR) for Capital Programme	627	809	868	911	930	940	947	1,011
2.*Less* Other Debt Liabilities	(66)	(62)	(57)	(51)	(46)	(42)	(38)	(7)
3.Underlying need for loans (Loans CFR)	**561**	**747**	**811**	**860**	**884**	**898**	**909**	**1,004**
4.*Less* Core funds	(355)	(354)	(323)	(284)	(248)	(242)	(240)	(255)
5.*Add* Liquidity Allowance	50	50	50	50	50	50	50	50
6.Net Loans Requirement	**256**	**443**	**538**	**626**	**686**	**706**	**719**	**799**

Figures to 2024/25 are based on the capital programme. Figures 2028/29 are based on aspirational capital schemes included in the Appendix to Part 1.

1.Underlying need to borrow

The Council's underlying need to borrow is measured by its capital financing requirement (CFR). The CFR is the cumulative amount of capital expenditure financed by borrowing less the MRP set aside to repay that debt. The CFR therefore increases when capital expenditure is financed from borrowing and decreases when MRP is set aside to repay debt. There is no direct relationship between the CFR and actual borrowing.

2.Other Debt Liabilities

Finance leases and private finance initiative (PFI) schemes take the legal form of leases, but are in substance borrowing relating to specified assets.

3.Underlying need for loans (loans CFR)

This is the Council's underlying need to borrow excluding finance leases and PFI schemes that finance specific assets, and is known as the loans CFR.

4.Usable Reserves

These are the Council's cash backed reserves including general balances and earmarked reserves. The Council can temporarily borrow internally from these reserves to fund capital expenditure as an alternative to external borrowing. This can be beneficial as the cost of borrowing externally often exceeds the interest that can be earned from investing these funds. However, the Council will need to undertake external borrowing when these funds are spent on the purposes for which they are intended, and there is a risk that interest rates on borrowing could increase in the meantime.

5.Liquidity Allowance

The Council's cash balances are quite volatile and tend to fall towards the end of the financial year when there is less taxation revenue income. It is therefore necessary to make an allowance for this volatility in cash balances.

6.Net Loans Requirement

This is the amount of borrowing required after taking account of other forms of borrowing such as finance leases and PFI schemes, usable reserves, and volatility in cash balances. As such it represents a neutral benchmark for treasury management activity.

The Council's current position against this benchmark is as follows.

Table C	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2029/30**
	£m	£m	£m	£m	£m	£m	£m	£m
Net Loans Requirement	**256**	**443**	**538**	**626**	**686**	**706**	**719**	**799**
Long Term Borrowing	590	658	649	641	633	625	617	552
(Over) / Under Benchmark	**(334)**	**(215)**	**(111)**	**(15)**	**53**	**81**	**102**	**247**

Interest rates on borrowing have been exceptionally low and the Council has borrowed sufficient funds to last it until 2021/22. This has secured long term funding at low interest rates to fund the Council's capital programme, but does expose the Council to a cost of carry, ie. the rates at which funds were borrowed exceeding the rates at which the funds can be invested, and the risk of investments defaulting in the meantime.

2. Investment of Surplus Cash

All council cash investments have been in accordance with the council's Treasury Management Policy.

The Council is forecast to have a significant amount of core surplus cash after internal borrowing has been taken into account in 2020/21 (Table C).

2.1 Due Diligence

The Council initially identifies suitable investments using credit ratings from Fitch, Moody's, and Standard and Poor. Where possible, credit ratings are compared to insurance premiums against a counter party defaulting. Insurance premiums against a counter party defaulting can be compared to a widely used index of the market (ITRAAX). If the market has concerns about a borrower, it should be reflected in a higher insurance premium. Although credit ratings are supported by an in depth analysis of the borrower, insurance premiums provide a more up to date indicator of a borrower's credit worthiness. Prior to making investments, any news relating to the borrower is also taken into account.

Other sources of information that is relevant to particular sectors is also taken into account either as a substitute for credit ratings and insurance premiums in sectors where these are not available or to supplement credit ratings and insurance premiums. Examples of this are the governance and viability ratings assigned to larger registered social landlords (RSLs) by the Homes and Communities Agency (HCA), and data sets published by the Building Societies Association

For further detail on the Council's investment criteria, see the Treasury Management Policy.

2.2 Investment in Commercial Properties Acquired Through the Capital Programme

According to the CIPFA Treasury Management Code, investment properties acquired through the capital programme are regarded as investments in addition to investments of surplus cash.

2.3 Statutory Guidance

The Government issued revised statutory guidance on local government investments early in 2018 coming into effect from 1st April 2018. The guidance requires Councils not to borrow to acquire investment property portfolios outside their economic area in order to generate profits.

The Government's revised statutory guidance also requires local authorities to present a range of indicators to allow members and other interested parties to understand the total exposure from borrowing and investment decisions. It is recommended that the indicators contained in Appendix A be approved. The Government's statutory guidance requires the Council to consider the long term sustainability risk implicit in becoming too dependent on commercial income or in taking out too much debt relative to net service expenditure. In particular, the Government's statutory guidance requires the City Council to set limits that cannot be exceeded for gross debt compared to net service expenditure, and for commercial income as a percentage of net service expenditure. It is recommended that if these limits are exceeded, the Director of Finance and Resources (Section 151 Officer) bring a report to the Cabinet and City Council.

2.4 Activity in the Investment Property Market

Prior to this guidance coming into effect, as at 31 March 2018, the Council had spent £128m on acquiring commercial properties outside the Portsmouth economic area solely to generate income to support the services that the Council provides.

The Council's capital programme provided for £182.9m for the acquisition of commercial properties.

a. £159.7m of this budget was spent by 31st March 2019
    I. £13.6m on Portsmouth Retail Park and
    II. £146.1m outside the Portsmouth economic area, leaving
b. £23.2m to be spent in 2019/20 and subsequent years. £12.3m of this sum is expected to be spent in 2019/20, leaving £10.9m to spend in 2020/21.

In 2016/17, the Council borrowed to take advantage of available cheap borrowing which then financed these purchases in 2016/17 prior to the Government issuing its revised guidance. In addition, it was felt that the commercial property acquisition programme needed to continue in order to create a balanced portfolio. Having regard to the guidance, the Council has concluded that the money already borrowed to finance the purchase of investment properties should be used for that purpose. The Council's capital programme provides for commercial properties outside the Portsmouth area to continue to be purchased up to the limit of the existing capital budget.

All such acquisitions require a business case and full financial appraisal. All previous acquisitions were approved by the Director of Property and the Section 151 Officer in consultation with the Leader of the City Council.

The detailed business case and financial appraisal includes building surveys, environmental surveys and valuations in accordance with the Red Book. In addition, properties are revalued on an annual basis.

The Commercial Property Portfolio is managed by an in house team who are qualified members of Royal Institute of Chartered Surveyors. An annual report on the Property Investment Fund is prepared for the Cabinet and City Council by the Assistant Director for Property and Investment. This report covers the composition of the Fund, rental income, acquisitions, current strategy, and capital growth.

2.5 Investment Indicators

The investment indicators are contained in appendix 2.

Gross General Fund (GF) Debt to GF Net Service Expenditure

The Councils GF borrowing is forecast to be 2.9 times its GF net service expenditure in 2020/21. It is recommended that GF borrowing be limited to 4.0 times GF net service expenditure. This will allow further borrowing to be undertaken if it is financially advantageous.

Income from Investments to General Fund (GF) Net Service Expenditure

The Council will depend on income from investments to fund 5.3% of its estimated GF net service expenditure in 2020/21. In order to ensure that the Council does not become over dependent on income from investment income it is recommended that no more than 7.9% of GF net service expenditure will be funded from income from investments.

Interest Cover

The Council's investment property portfolio has been financed from borrowing. There is therefore a risk that income from investment properties may be insufficient to pay the interest incurred on the associated debt. However, the net income from the investment property portfolio exceeds the cost of the associated interest 2.6 times. The interest cover is greater than this in other years.

Loan to Value Ratio

There has been a small reduction in the current market value of the investment property portfolio and the value of the portfolio is below its cost including fees associated with the purchase of properties.

Forecast Income Returns

The investment property portfolio is expected to make a net return of 3.39% in 2020/21.

Long term treasury management investments are expected to make a net return of 1.44% in 2020/21 although this is expected to fall to 0.9% in the following years as existing investments mature and cannot be replaced with investments making similar returns.

Gross and Net Income from Investment Properties

The investment property portfolio is expected to generate a retained income of £5.1m in 2020/21.

External Operating Costs

External operating costs vary between years depending on the timing of lease events, with some years having more lease events than others.

3. Skills and Knowledge

The issues covered by this report are in their nature complex so all the Council's senior finance staff are chartered accountants. Where the Council does not have the necessary in-house skills and services, it employs Link Asset Services to provide interest rate and economic forecasts, and counter party information.

The Finance Manager (Technical and Financial Planning) who manages the treasury function also holds the Association of Corporate Treasurers Certificate in Treasury Management. The Finance Manager (Technical & Financial Planning) is assisted by the Treasury Manager who is a qualified Chartered Certified Accountant and also holds the Association of Corporate Treasurers Certificate in Treasury Management.

At 31 March 2019 £36,230,000 of the Council's investments of surplus cash were being managed externally consisting of £28,380,000 invested in instant access money market funds and £7,850,000 invested in corporate bonds that were being externally managed.

The City Council is also a member of Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management Network which provides training events throughout the year. Some training is also provided by Link Asset Services. Additional training for investment staff is provided as required.

Councillors are offered training by an external consultant to provide them with an over view of treasury management after the local government elections.

4. Treasury Management Reporting

Treasury management has been defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) as "the management of an organisations borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks". Put simply, the Council's approach to cash flow includes:

- borrowing when the Council requires more cash
- Investing when the Council has surplus cash

In addition to the Capital strategy, the Council also has a Treasury Management strategy. The Treasury Management Strategy contains:

- the Treasury Management Indicators that set the boundaries within which treasury management activities will be undertaken and
- an Annual Investment Strategy that specifies how surplus cash will be invested

To demonstrate good governance, all treasury management reports are taken to the Governance and Audit and Standards Committee and all Treasury management reports requiring policy decisions are taken to the Cabinet and the City Council.

Report	Reporting of Compliance & Performance in Previous Period	Policy Changes	Audience
Treasury Management Policy		Yes	G&A&S Committee Cabinet City Council
Treasury Management Quarter 1 Monitoring	Yes		G&A&S Committee
Treasury Management Mid-Year Review	Yes	Yes	G&A&S Committee Cabinet City Council
Treasury Management Quarter 3 Monitoring	Yes		G&A&S Committee
Treasury Management Outturn	Yes		G&A&S Committee Cabinet City Council