

## 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 Net Debt

Borrowings increase when capital schemes are financed from borrowing and decrease when debt is repaid.

The Council's reserves and working capital are invested until the money is required to finance expenditure.

The Council's forecast net debt, ie. its borrowings less its investments are summarised in the table below. This forecast is based on the Council using its reserves to finance capital expenditure in the medium term, rather than undertaking new external borrowing for as long as possible. This is beneficial to the Council's revenue budget as the interest on borrowings normally exceeds the return on the Council's investments. However, this position cannot be maintained in the long term with the Council's net debt increasing year on year, and it is expected that the Council will have to undertake further external borrowing or sell investment properties in 2023/24.

	<b>2021/22</b>	<b>2022/23</b>	<b>2023/24</b>	<b>2024/25</b>	<b>2025/26</b>	<b>2026/27</b>
	£m	£m	£m	£m	£m	£m
Borrowings	762	757	830	869	862	858
Less Investments	(301)	(145)	(50)	(50)	(50)	(50)
<b>Net Debt</b>	<b>461</b>	<b>612</b>	<b>780</b>	<b>819</b>	<b>812</b>	<b>808</b>

### 2 Borrowing

In the past, the principal source of borrowing has been the Public Works Loan Board, (PWLB) which is operated by HM Treasury. The PWLB can still be used to replace existing debt or to reschedule debt. However, a recent change in the PWLB's lending terms requires Local Authorities to confirm that they do not plan to purchase investment assets primarily for yield. There is currently further investment planned within the commercial property acquisition fund contained within the capital programme and as a consequence the Council does not currently comply with these revised lending conditions. Consequently the Council will need to use alternative sources of borrowing to fund new capital expenditure or cancel its plans to invest in commercial properties primarily for yield in order to retain access to the PWLB as a source of borrowing .

There are now alternative sources of borrowing available including public listed bonds and private placements. A public listed bond could be cheaper than the PWLB but would require a minimum sum of £100m to be borrowed and the Council would need to obtain a credit rating. A private placement would have a similar cost to the PWLB but would require a minimum sum of £30m to be borrowed and would be subject to a credit assessment by prospective lenders.

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 directly accrue 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; although premiums would be payable to the lender and consequently early redemption and rescheduling are rarely financially beneficial to the Council.

## 2.1 Affordability of Borrowing

To ensure future budgets remain affordable, except for 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.

Following the decision by the PWLB on 25 November 2020 to decrease their margin over gilt yields by 100 bps to 80 basis points on loans lent to local authorities, interest costs on new borrowing will be significantly lower. At the same time the Chancellor denied access to the PWLB for any local authority that has the purchase of assets primarily for yield, such as commercial properties, in its three-year capital programme.

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. The distribution of MRP over the life of a capital scheme is determined by the prevailing interest rate. The lower the interest rate, the higher the MRP is in the early years. Therefore, although the interest costs on new borrowing will be lower, MRP in the early years will be higher.

The Council reviewed how it provided for the repayment of its debt. It was felt that the previous methods used in the past have resulted in over provisions of MRP from 2008/09 to 2015/16 amounting to £22.6m. The Director of Finance and Resources (Section 151 Officer) has been releasing the over provision of MRP back into General Fund balances at a rate of around £2m per annum under delegated authority. It is estimated that all the over provision will have been released back into General Fund balances by 2026/27.

It is estimated that MRP will amount to £11.1m in 2022/23.

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

## 2.3 Key Risks

There are risks with borrowing more than the Council can afford. 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.

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

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 year. It is not a limit but acts as a warning mechanism to prevent the authorised limit (above) being breached.

## 2.4 Sensitivity Analysis

The Council's gross debt on 31<sup>st</sup> March 2021 was as follows:

	£m	£m
Fixed Rate Borrowing	644	
Finance Leases	1	
Private Finance Initiative (PFI) Schemes	56	
Sub Total - Fixed Rate Debt		701
Lenders Option Borrowers Option (LOBO) Loan	11	
Retail Price Index (RPI) linked loan	66	
Sub Total - Variable Rate Debt		77
<b>Total Gross Borrowing</b>		<b>778</b>

90% 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 2023. If the lender does increase the interest rate the Council, then has the option to repay the loan.
- The Council has £66m 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.

## 2.5 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
<u>General Fund Borrowing:</u>	
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 with an expected holding period of under 50 years	The repayment of unsupported borrowing will be provided for by setting aside the capital receipt when the property is disposed of unless the carrying (market) value of the property falls below that part of the purchase price financed from unsupported borrowing. If this happens MRP will be made for the shortfall over the residual life of the property
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
<u>Housing Revenue Account (HRA)</u>	No MRP debt will be provided until 2024/25. From 2025/26 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. Consequently, 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.

### 3 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 for the foreseeable future.

#### **3.1 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 considered.

Other sources of information that is relevant to particular sectors is also considered 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.

#### **3.2 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.

### **3.3 Statutory Guidance**

The Government issued revised statutory guidance on local government investments early in 2018 coming into effect from 1<sup>st</sup> April 2018. The guidance requires Councils not to borrow purely for financial gain.

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 the Appendix 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.

### **3.4 Activity in the Investment Property Market**

Prior to this guidance coming into effect, as 31 March 2018, the Council had spent £117.3m on acquiring commercial properties outside the Portsmouth economic area solely to generate income to support the services that the Council provides. The Council has since spent a further £41.6m on acquiring commercial properties outside the Portsmouth economic area to create a balanced commercial property portfolio. There are no further commercial property acquisitions outside the Portsmouth economic area in the Capital Programme, although there is a scheme to refurbish one of the investment properties.

All acquisitions were supported by a business case and full financial appraisal 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 included 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 the Royal Institute of Chartered Surveyors.

### **3.5 Investment Indicators**

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

The Council's GF borrowing is forecast to be 3 times its GF net service expenditure in 2022/23. It is recommended that GF borrowing be limited to 5 times GF net service expenditure in 2022/23. This will allow further borrowing to be undertaken if it is financially advantageous.

#### *Income from Investment Properties to General Fund (GF) Net Service Expenditure*

The Council will depend on income from investment properties to fund 4.5% of its estimated GF net service expenditure in 2022/23. To ensure that the Council does not become over dependent on income it is recommended that no more than 7.5% of GF net service expenditure will be funded from investment income.

### *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 2.3 times.

### *Loan to Value Ratio*

The Council's investment property portfolio has only recently been acquired, but the market value of the properties is thought to be sufficient to repay the borrowing that financed their acquisition.

### *Forecast Income Returns*

The investment property portfolio is expected to make a net return of 2.6% against the value of the properties in 2022/23. There is a dip in the net income from the investment property portfolio in 2022/23 due to one of the properties being refurbished.

### *Gross and Net Income from Investment Properties*

The investment property portfolio is expected to generate a retained income of £4.0m in 2022/23.

### *External Operating Costs*

External operating costs are driven by lease events such as rent reviews and lease renewals. Some years have more lease events than others.

## 4. 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 holds the Association of Corporate Treasurers Certificate in Treasury Management.

On 31 March 2021 £52,210,000 of the Council's investments of surplus cash were being managed externally consisting of £44,510,000 invested in instant access money market funds and £7,700,000 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 overview of treasury management after the local government elections.

## 5. 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

## 6. Revisions to the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code and Prudential Code

CIPFA published revised codes on 20th December 2021 and has stated that formal adoption is not required until the 2023/24 financial year. This Council must have regard to these codes of practice when it prepares the Treasury Management Strategy Statement and Annual Investment Strategy, and related reports during the financial year, which are taken to Full Council for approval.

The revised codes will have the following implications:

- a requirement for the Council to adopt a new debt liability benchmark treasury indicator to support the financing risk management of the Council's underlying need to borrow. This is currently measured by the capital financing requirement which is a measure of the Council's gross underlying need to borrow. The new debt liability benchmark is a measure of the Council's net underlying need to borrow, ie. its underlying need to borrow, less its treasury management investments which could be liquidated as an alternative to undertaking new borrowing;
- clarify what CIPFA expects a local authority to borrow for and what they do not view as appropriate. This will include the requirement to set a proportionate approach to commercial and service capital investment;
- address environmental, social and governance (ESG) issues within the Capital Strategy;
- require implementation of a policy to review commercial property, with a view to divest where appropriate, eg. if the Council needed to borrow and the cost of borrowing exceeded the return on commercial properties;
- create new Investment Practices to manage risks associated with non-treasury investment (like the current Treasury Management Practices);
- ensure that any long-term treasury investment is supported by a business model;
- a requirement to effectively manage liquidity and longer-term cash flow requirements;
- a requirement to address ESG policy within the treasury management credit risk framework;
- a requirement for a knowledge and skills register for individuals involved in the treasury management function - to be proportionate to the size and complexity of the treasury management conducted by each council;
- a new requirement to clarify reporting requirements for service and commercial investment, (especially where supported by borrowing).

In addition, all investments and investment income will have to be attributed to one of the following three purposes: -

**Treasury management**

Arising from the organisation's cash flows or treasury risk management activity, this type of investment represents balances which are only held until the cash is required for use. Treasury investments may also arise from other treasury risk management activity which seeks to prudently manage the risks, costs or income relating to existing or forecast debt or treasury investments.

**Service delivery**

Investments held primarily and directly for the delivery of public services including housing, regeneration, and local infrastructure. Dunsbury Park, Portsmouth Retail Park, Portico and Ravelin would be included in this category. Returns on this category of investment which are funded by borrowing are permitted only in cases where the income is "either related to the financial viability of the project in question or otherwise incidental to the primary purpose".

**Commercial return**

Investments held primarily for financial return with no treasury management or direct service provision purpose. Risks on such investments should be proportionate to a council's financial capacity – i.e., that 'plausible losses' could be absorbed in budgets or reserves without unmanageable detriment to local services. An authority must not borrow to invest primarily for financial return.

Members will be updated on how all these changes will impact our current approach and any changes required will be formally adopted within the 2023/24 Capital Strategy and Treasury Management Policy.

