Item 7

Corporate Services Overview and Scrutiny Committee

17 September 2014

County Council Borrowing Strategy

Recommendation

That the Corporate Services Overview and Scrutiny Committee is recommended to note and comment on the information on the Council's borrowing detailed in the report.

1. Purpose of the report

1.1. Following a motion to Council 21 July 2015 it was resolved that the Corporate Services Overview and Scrutiny Committee should investigate taking advantage of current low interest rates to borrow more through long term bonds and to raise debt ratios with a view to investing to ensure Warwickshire emerges from the recession in better shape that its peers.

1.2. This report provides the background information to allow the Committee to consider the issue in more detail. It outlines:

- The legislative background against which all decisions about borrowing to fund capital investment take place,
- Our current level of borrowing
- Our relative debt levels compared to other shire counties
- The affordability of additional capital investment
- The alternative options available for raising funding, and
- The relative priority of capital investment compared to other spending needs.

2. Legislative background

2.1. As a result of changes introduced in the Local Government Act 2003 local authorities are able to borrow funds for capital investment provided the plans

are prudent, affordable and sustainable. Essentially this means we can borrow to invest provided the following criteria are met:

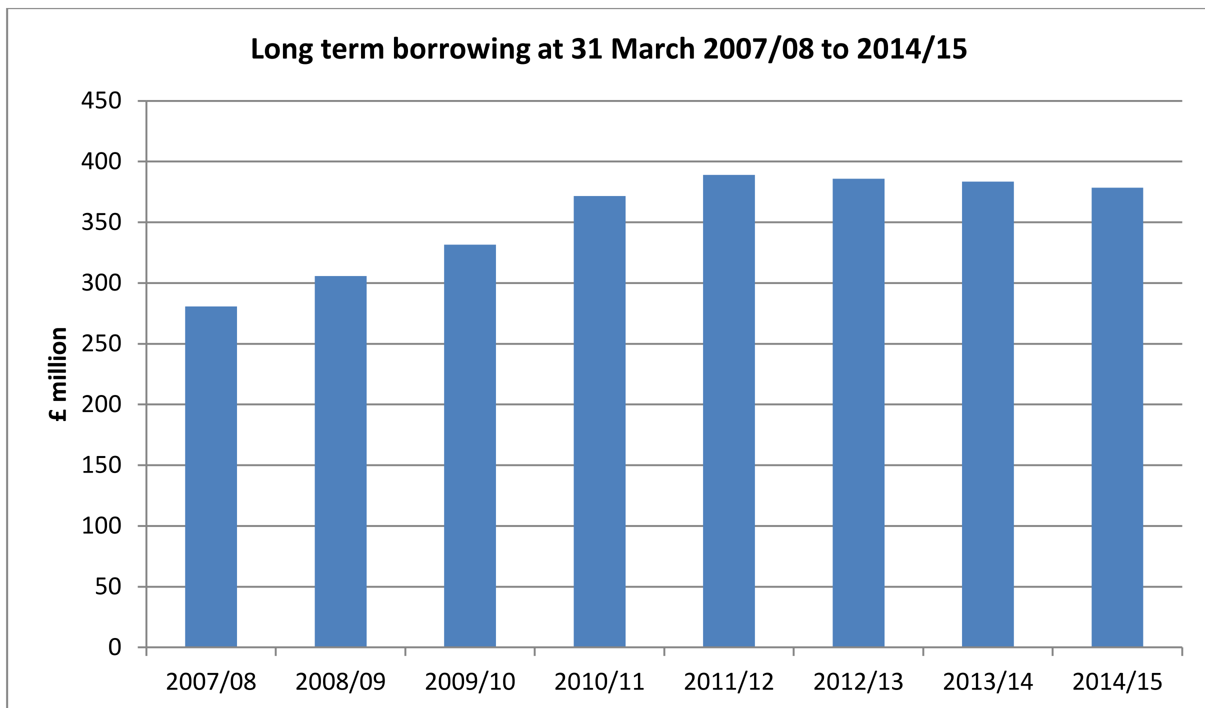
- The investment results in the creation of a long term asset (we are not permitted to borrow to fund revenue spending).
- The revenue costs that flow from the investment (interest charges from the additional borrowing or additional running costs as a result of the capital projects) are fully provided for within the revenue budget.
- The on-going liabilities created, including putting sufficient funding aside to repay the loan over the medium/long term, is sustainable and affordable given future plans and financial projections.

2.2. The money we put aside to repay the loan is known as the ‘Minimum Revenue Provision’ and enables the spreading of the cost of the capital spend (equivalent to the repayment of the ‘principal’ element of any loan). The number of years over which this spreading is allowed to take place has to be prudent and this is measured as broadly spreading the cost over the number of years the community benefits from the asset that is created. For example, the capital cost of a vehicle which is expected to have a useful life of 5 years is spread over 5 years whereas for a building the capital cost may be spread over 25 or 30 years. On average the useful life of our assets is 20 years.

2.3. Whilst the legislation provides a framework, it is ultimately a matter of judgement as to whether the size of the capital programme is prudent, affordable and sustainable. Members will have a view as to where that level is, or should be, and this level has to be acceptable to the Head of Finance. There is no right or wrong answer and therefore the following sections outline some of the factors for a local authority to take into account when making that judgement.

3. Absolute level of long term borrowing

3.1. Our long term borrowing (as at 31 March 2015) is £378 million. The level of borrowing has been on a slight downward trajectory since reaching a peak of £389 million at the end of 2011/12 but this is still significantly above historic levels. The annual position from 2007/08 is shown in the chart below.



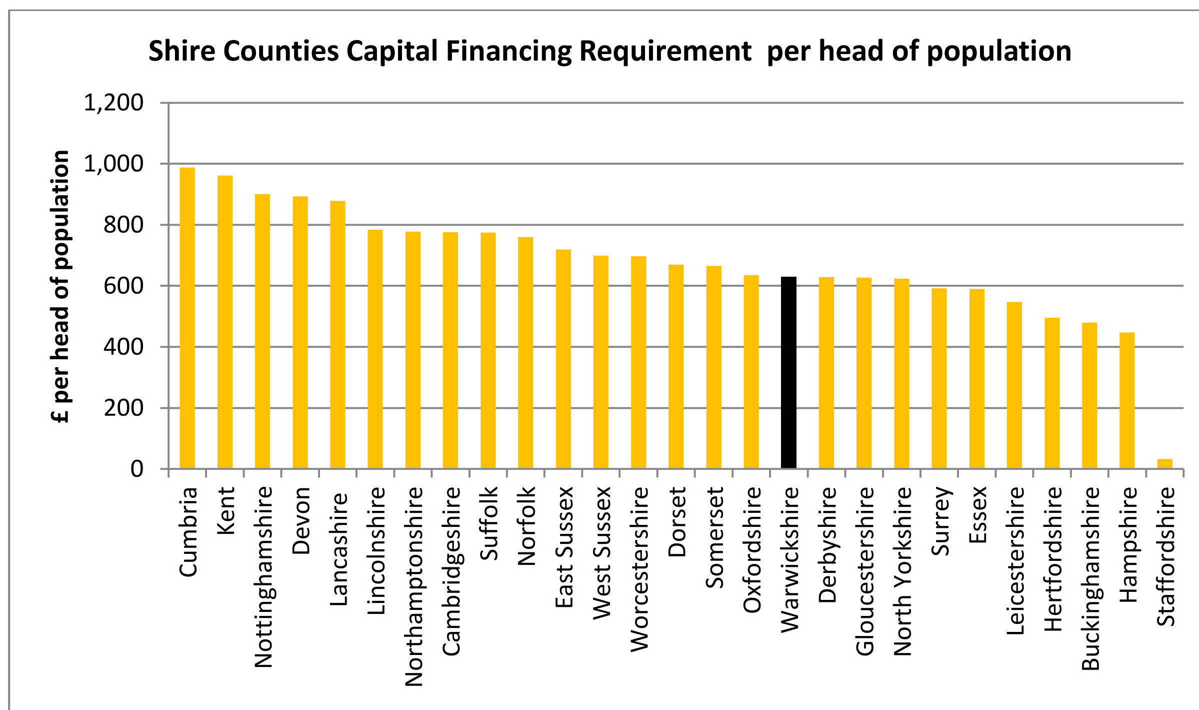
3.2. At £378 million our level of long term debt outstanding is significantly less than the £1.3 billion value of the assets it has helped to finance. We therefore have a healthy debt to asset value ratio that would not preclude taking out additional borrowing, subject to the borrowing being for a purpose which takes priority over other potential uses of the revenue funding required to service the capital debt.

4. Relative level of borrowing

4.1. Whilst as a local authority we are not allowed to borrow in advance of spending needs in order to profit from the investment, it is a matter of judgement as to when it is most financially advantageous to borrow in light of current and future known borrowing requirements.

4.2. At all times this means any local authority is more than likely to be under/over borrowed compared to the actual level of capital spend that needs to be financed. The level of capital spend that has to be financed is called the Capital Financing Requirement (CFR). Currently, as a result of slippage in the capital programme, running down of surplus cash balances (due to minimal scope for earning interest) and the level of capital receipts generated as a result of property rationalisation we are over borrowed. At 31 March 2015 our CFR was £305 million. At the current time this a common position for local authorities to be in. It also allows us to mitigate credit and interest rate risk.

4.3. Our CFR is £630 per head of population. This places the authority just below average in terms of the CFR per head of population across all shire counties, as shown in the chart below. We are in the same ranking position when you look are the ratio of our CFR to the level of income we generate from council tax.



4.4. This would suggest that there is nothing in our relative level of borrowing compared to other shire counties that would indicate taking out additional borrowing to support capital investment would be imprudent, subject to the borrowing being for a purpose which takes priority over other potential uses of the revenue funding required to service the capital debt.

5. Affordability

5.1. The affordability of additional capital investment funded from borrowing is determined by looking at the impact on the revenue budget. The 2015/16 budget for capital financing costs is £39.8 million. This is both affordable and sustainable with borrowing at its current level of £20 million a year. The £39.8 million is equivalent to 12% of our budget requirement (council tax plus business rates plus revenue support grant).

5.2. Any borrowing above this level would need to be provided for in the revenue budget as a commitment against the provision for new spending pressures in the OOP Medium Term Financial Plan. The MTFP currently has £5 million a

year included for new spending pressures or for the alleviation of savings targets. If the increase in the revenue cost as a result of the capital investment is above this level additional savings or income would need to be identified.

5.3. Currently, we can borrow at low interest rates, depending on the period of time over which we take out the loan. However, in budgeting terms we also need to spread the cost of the principal repayments over the period of the useful life of the asset.

5.4. Assuming we spend £10 million purchasing/constructing an asset which will have a useful life of 20 years then the additional allocation needed in the revenue budget would be:

Period of Loan	Interest rate	Annual Interest Payment £m	Annual Principal Repayment £m	Total Cost £m
1 year	1.31%	0.131	0.500	0.631
5 years	2.35%	0.235	0.500	0.735
10 years	3.06%	0.306	0.500	0.806
20 years	3.29%	0.329	0.500	0.829
25 years	3.66%	0.366	0.500	0.866

5.5. This would suggest on cost terms a 1 year or short term loan should be taken out initially to finance the spend. However, to do this at the lowest costs relies on being able to refinance the loan at the same interest rate every twelve months for 20 years. Taking short term loans increases the financial risk and uncertainty. From a long term sustainability and affordability perspective it is therefore often an option to take out a slightly higher cost loan where the cost is certain for a longer period. The exception to this would be where it is known that additional income as a result of the investment or a material capital receipt means the loan would not need to be refinanced at the end of the loan period or would be available to mitigate any higher costs at the point of refinancing the loan.

5.6. The final judgement on whether additional capital investment is affordable is a complex mix of assessing not only the revenue cost of the investment itself and any additional income that it would generate but also what other pressures there are on the Council's scarce resources at the time the decision is made. There is nothing, in terms of affordability, that would automatically preclude additional capital investment, if it is of sufficient value to the authority.

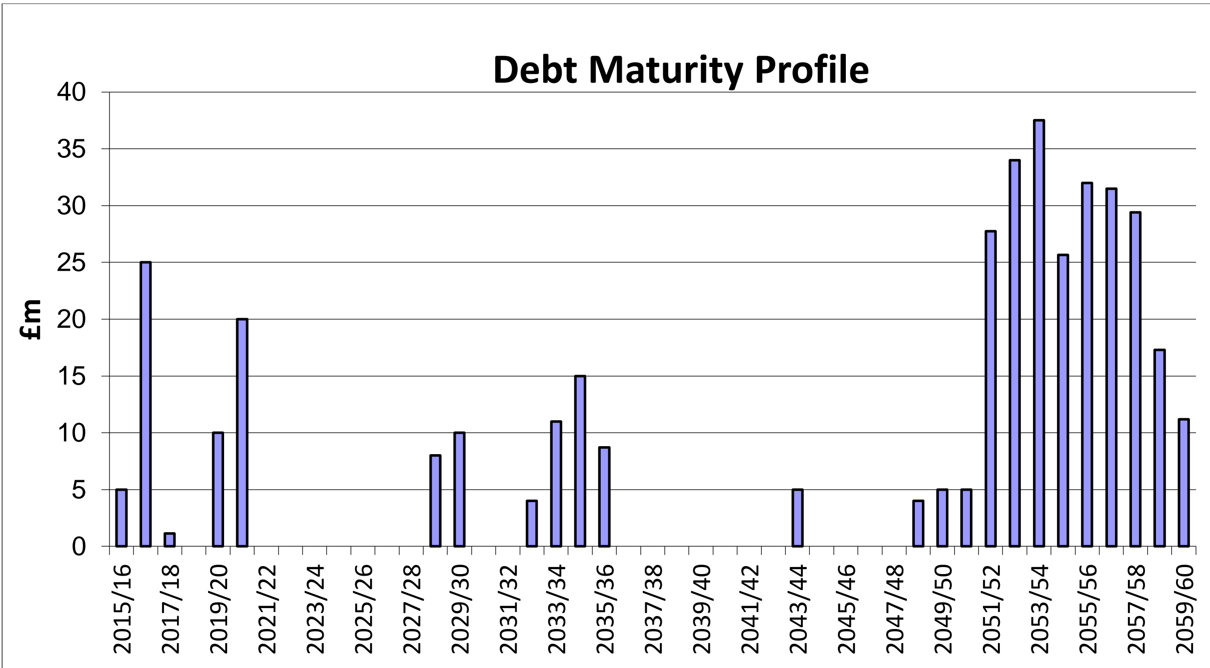
6. Options for raising finance – Public Works Loans Board

6.1. All our current loan finance is from the Public Works Loans Board (PWLB). This is common with most local authorities, with three quarters of all local authority loans from the PWLB. The PWLB is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. PWLB's function is to lend money from the National Loans Fund to local authorities, and to collect the repayments. The reason it is so widely used is that it provides loans at lower rates of interest than authorities could obtain from commercial banks.

6.2. The PWLB also provides almost instant access to finance. The interest rate is the published daily rate on offer on the day you arrange the loan and the funds are received two business days after the deal is arranged.

6.3. PWLB loans also provide flexibility as they are not linked to the purchase of a specific asset. As with all local authority's we do not generally borrow to finance individual assets but rather on the entirety of the planned capital programme over the medium to long term. We also take out loans at fixed rates for long periods, including up to 50 years, as this provides stability and certainty. Historically this has also been financially advantageous as long term rates are usually lower than short term rates. It is only in the current recession that this pattern has been reversed.

6.4. The chart below shows the debt maturity profile of our current loans.



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6.5. As can be seen we have £61.150 million of loans due for repayment before the end of March 2021. This comprises 8 individual loans of varying amounts, loan periods and interest rates, as shown in the table below. The smaller of these loans were originally taken out when interest rates were high and we expect to be able to re-finance them, when the loans become due, at a lower rate of interest, so reducing the authority's interest costs. However, with interest rates likely to rise before the majority of the loans become due it may be that refinancing the other loans more than offsets any savings.

Year of final repayment	Loan period (years)	Amount £m	Interest rate %
2015/16	27.5	5.000	9%
2016/17	6.5	10.000	2.74%
	28.5	5.000	9%
	7	10.000	2.88%
2017/18	26	1.150	9.75%
2019/20	9.5	10.000	2.99%
2020/21	9.5	10.000	3.71%
	10	10.000	3.81%

6.6. In terms of the cost of any new PWLB borrowing, in additional to maintaining the current loan portfolio, PWLB currently provide a new loan rate which is 1% above the UK gilt rate for the relevant loan period. They also currently offer a 'certainty rate' which is set at 0.2% below the new loan rate (or 0.8% above the UK gilt rate) which we currently qualify for.

7. Options for raising finance – bonds

7.1. The main alternative to using the PWLB as a source of loan financing is bond issues. Interest in these has increased particularly as the banks, excluding PWLB, are no longer lending for long maturity periods. There are two ways to do this as a sole issuer or via a pool.

7.2. Sole Issue Bonds

There is scope to go to market as a sole issuer and seek funding from institutional investors who have an appetite for our credit quality and longer dated lending. To go down this route would require us to engage some form of market maker to build a book of investors and create the funding needed. This process would include agreement on the loan structure and an indicative funding rate. The rate would only be indicative as the actual rate will only be

determined when all the paperwork has been agreed and funding is in place. This process could take up to 3 months with the cost linked to the size of the bond being issued.

In advance of starting this process we would probably need to get a separate credit rating. A credit rating is an evaluation of the credit worthiness of a company or a government. The evaluation is made by a credit rating agency and is assessed on the ability to pay back the debt and the likelihood of default. There would be a cost to gaining a credit rating of up to £50,000.

A small number of authorities have credit ratings. Some do this for status and others to raise their profile when they are seeking funding as this will provide the investor with a clearer understanding of the credit quality they are lending to. If the County Council were to issue a bond we would probably need to do this to achieve the best funding rate. However, obtaining an individual credit rating is a risk. Without one we would probably be assigned the UK Government rating of AA+ but if we were to seek our own rating it may fall below this and increase the cost of funding. For example, Woking BC has an AA rating which is below the UK Government rating of AA+. Cornwall Council has an AA+ credit rating.

The only current example of a local authority that has gone down the route of a sole bond issue is the GLA who issued a bond for £600 million to raise funding for Transport for London's investment in cross-rail in 2011. The GLA initially raised the funding at 0.8% above the gilt rate, but these bonds now trade slightly higher at 0.85% above the gilt rate. This indicates institutional investors want a better return than they would get if they lend below current PWLB certainty rates.

In practical terms to issue a sole bond and achieve rates at or below the PWLB certainty rate and make the additional costs of going down this route worthwhile we would need to be looking to raise upwards of £100 million for a specific project.

7.3. Pooled Bond Issue

An alternative is to go to the market with other local authorities and form a pool of borrowers. This would get a synthetic rating which would then determine the bond pricing which the book of investors agree to lend at. Again this would require a similar/the same funding process as the individual bond and may require each authority in the pool to agree to cover any credit losses which arise on the bond. This may mean we could be asked to cover someone else's debt.

7.4. The Municipal Bond Agency

The Local Government Association's Municipal Bond Agency is a similar arrangement, specifically designed to allow local government to access the bond markets to raise capital funds as an alternative to using the PWLB. Council have already approved our membership as one of the founders of the Municipal Bond Agency.

The underlying assumption is that the market will price any bonds offered competitively and so will increase the diversification of the local government financing market and potentially drive down the cost of borrowing either directly or by encouraging the PWLB to bring down its prices.

The added benefit of the going through the Agency is that it allows individual authority's to defray the costs of compliance and infrastructure and makes use of wider expertise than available to an individual authority. However, using the Agency approach does require an element of risk sharing, as with all bond agencies/pooling arrangements and this is part of the trade-off of the reduced costs of an Agency solution.

The Municipal Bond Agency has yet to issue its first bond and their credit rating is still pending. It is anticipated that this source of funding will be cheaper than the PWLB certainty rate but until the first issue this will not be known.

8. Priority of additional capital investment

8.1. In the previous sections this report has outlined the range of issues that would be taken into account when considering if additional capital investment would be prudent, sustainable and affordable. It has also considered the main options available for raising the necessary loan finance. The analysis has shown that there is nothing technically or financially that would preclude the authority undertaking at least some degree of additional capital investment.

8.2. It is current Council policy to restrict borrowing and use capital receipts to repay debt as a way of releasing revenue resources to reduce the level of savings needed. As a result the decision on the level of capital borrowing is one for Members based on a balance of political and service priorities, taking into account the advice of the Head of Finance on the prevailing market conditions at the time and would mean a change of Council policy.

8.3. In deciding to make such a change and increase the level of capital investment there are two key factors that need to be evaluated:

- Is there a sufficiently defined capital scheme to invest in?
- Is the relative benefit/value of that scheme greater than the alternative uses for the revenue funding needed to finance servicing the borrowing?

8.4. To answer these questions, any projects to be funded either by a bond or additional scheme-specific PWLB borrowing would need to be significant (£20 million plus??) or be part of an infrastructure fund and would need to meet, as a minimum, a number of prerequisites:

- A business planning approach to the identification of need, including a thorough assessment of costs, timing, funding streams and responsibilities for delivery
- The existence of identified revenue schemes through which the authority would be able to recoup its up front capital investment and/or the identification of additional savings to meet the revenue costs.
- Robust and transparent governance arrangements to ensure appropriate levels of public accountability and scrutiny

9. Background Papers

9.1. None

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