London Borough of Enfield

General Purposes Committee

Meeting Date: 4 March 2021

Subject: **Capital Expenditure and Sensitivity of Interest Rates**

Cabinet Member: **Cllr Mary Maguire**

Executive Director: **Fay Hammond**

Purpose of Report

1. The Council has ambitious housing development and regeneration plans which are the key drivers for its capital programme. These are long term aspirations and rightly there is a Ten Year Capital Programme to give full visibility supported by a Ten Year Treasury Strategy.
2. These plans are fully affordable and accommodated within the Council's Five Year Medium Term Financial Strategy. This report sets out those commitments and importantly sets out the impact that movement of interest rates and other factors would have on the plans.
3. The Prudential Code regulating local authority borrowing which first came into force in 2004 is currently under review with a consultation running to 2 March 2021. The report will also provide an overview of the key elements of the consultation.

Proposal

4. General Purposes Committee is recommended to note the report.

Reason for Proposal

5. The report is for noting and to provide assurance that the sensitivities of interest rate movements are being effectively managed.

Relevance to the Council Plan

6. The Council Capital Programme targets resources at delivering the Council's Corporate Plan objectives of:
   a. Good Homes in Well Connected Neighbourhoods
   b. Safe, Healthy and Confident Communities
   c. An Economy that Works for Everyone.

Background

7. The Cabinet agreed the Capital Strategy and Ten Year Capital Programme and Ten Year Treasury Strategy to be considered at Council on 2 March 2021. The Council has an ambitious Capital Programme with a focus and housing development and regeneration.
8. The Capital Programme approves spend for 2021/22 and set out the plans for the Council over the longer term, ten year period. Delivering these plans

would commit the Council to net borrowing of £1.985bn by 31 March 2031 before easing back as contributions and receipts from the Meridian Water programme start to come through.

9. The capital financing costs are shared across the Council's General Fund, its Housing Revenue Account and by its wholly owned companies. The Minimum Revenue Provision MRP (notional repayment of the principal) and interest charges are built into the Five Year Medium Term Financial Plan.

10. The full details are available in the two reports to Council.

11. The Council took out £80m fixed term loans in 2019/20 which have replaced short term loans to actively reduce exposure to interest rate risk. Ensuring the debt does not all mature at the same time – the maturity profile section below will explore this further.

12. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer term stability of the debt portfolio. With short term interest rates currently much lower than long term rates, it is likely to be more cost effective in the short term to either use internal resources, or to borrow short term loans instead. However, given the size of the Council's Capital Programme, and the need to diversify the Council's debt portfolio, long term borrowing will also be required during 2021/22, the strategy is to fulfil the Council's borrowing requirement with a mixture of long and short term borrowing.

13. By taking short term borrowing, the Council is able to reduce net borrowing costs. The benefits of short term borrowing will be monitored regularly against the potential for incurring additional costs by deferring longer term borrowing into future years when long term borrowing rates are forecast to rise modestly. The Council's Treasury advisers Arlingclose assist the Council with this "cost of carry" and breakeven analysis. Its output may determine to what extent the Council borrows additional sums at long term fixed rates in 2021/22 with a view to keeping future interest costs low, even if this causes additional cost in the short term.

Managing Interest Rate Movements

14. The full impact of the approved Capital Programme is built into the Council's Medium Term Financial Plan. Appendix 1 is taken from the Council's Treasury Management Strategy and sets out the capital financing costs – both the notional repayment of principal, MRP (Minimum Revenue Provision) and interest across the General Fund, Housing Revenue Account (HRA) and the Council's wholly owned companies. For 2021/22 the Capital Financing costs are forecast at £33.062m. Of this sum:

    i. £8.705m is charged to Meridian Water and is added to the programme costs and will be met over the longer term from property and land receipts;

    ii. £4.898m is met by the Council's wholly owned companies a large proportion of which is with Housing Gateway Limited, the company which has been operating successfully to alleviate temporary accommodation pressures in the borough with the interest covered by rentals and the overall debt covered by a strong and secure asset base.

iii. £10.448m is met by the HRA which again is covered by rentals with the debt secured against the asset base and also with the back up of a thirty year Business Plan.

iv. £25.255m, the balance is met by the General Fund and included in the Council's 2021/22 Budget. It is equivalent to 9.7% of the Council's net revenue spend of £260.281m for 2021/22.

15. Interest rate risk is not across the whole debt portfolio of the Council. It is limited to maturing and new debt with existing fixed rate debt locked in over the long term.

16. The Council has adopted a prudent approach to its forecasts of interest rate costs and for business case purposes has assumed interest rates at 3.5%. Over the past ten years of austerity with the continued environment of low interest rates the Council's historical average rate of interest on its debt has declined. As at 31 March 2019 it was 3.05% and as at 31 March 2020 it was 2.69% and is forecast to reduce still further at the end of the current financial year.

17. This position will continue into 2021/22 and beyond with historical relatively more expensive debt maturing and being refinanced. Currently, the PWLB rate (23 February 2021) for a 20 year Equal Instalment of Principal loan is 1.81% with PWLB rates back at 0.8% over Gilts following a period of Government consultation across autumn 2020. Whilst PWLB has been the traditional source of debt for local authorities private sector debt is also attractive with the base rate at 0.1% and private placements and bond issuances are options which were not as competitive in the past.

18. The 3.5% rate for planning is therefore clearly prudent and gives headroom for future rate rises.

19. A key element of the Strategy to manage interest rate risk is to ensure that historical debt is not all maturing at the same time and potentially forcing the Council to reborrow when rates are more expensive. This is a relatively low risk for the Council as a large proportion of its existing debt is EIP (Equal Instalment of Principal) or Annuity borrowing in which case there would only be a need to partially refinance at most. When taking on new debt the duration of the borrowing will be influenced by the profile of the existing debt portfolio.

20. The Treasury Strategy and Capital Financing forecasts assume full, i.e. 100% delivery of the Council's Capital Programme. There has been additional challenge at the planning stage to establish realistic profiles for all schemes in the programme but there will almost certainly be slippage in delivery for a multitude of reasons. There is a recognised optimism bias in capital development programmes as described in the Government's Green Book for business cases. Slippage is of course a delay only and schemes will be ultimately be delivered and need to be financed. However, the delay does mean the financing is required later and in the meanwhile the Council is paying down its existing commitments. Enfield is not alone in the slippage in its planned work and there is a similar picture in other local authorities.

21. Whilst the Council sets out its capital investment plans in a ten year programme it is only committed to year one so for example for the Ten Year Programme 2021/22 to 2030/31 only 2021/22 is approved. The Programme is subject to annual review. In the face of unexpected rapidly rising interest

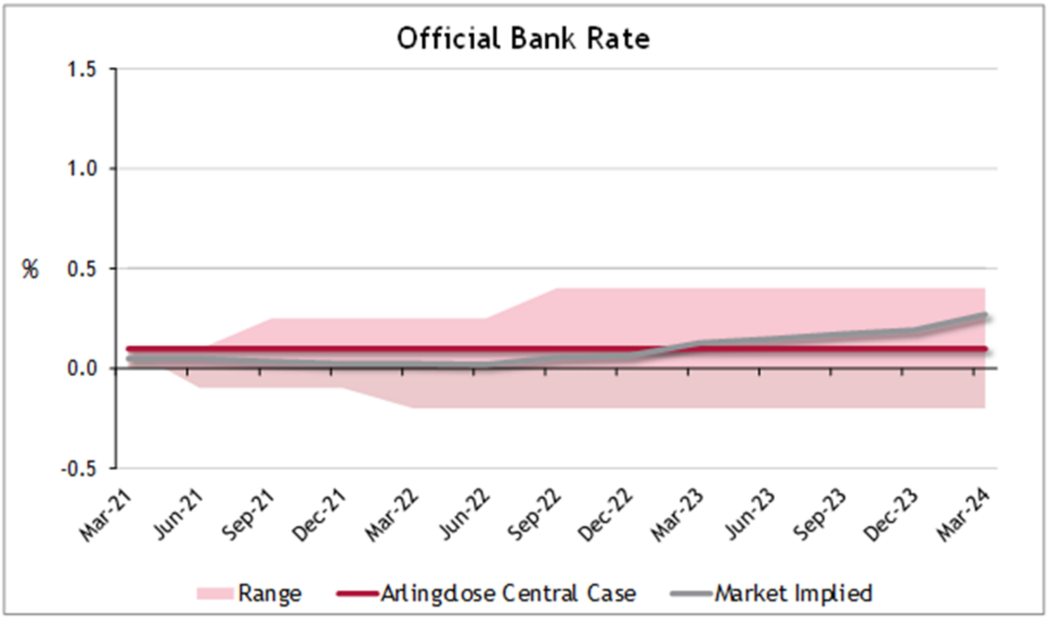
rates there would be a clear opportunity to review future planned commitments. Additionally, the Council does have the backing of specific and general reserves to smooth any unexpected and unplanned costs arising from interest rate rises on a one-off basis.

22. Finally, the Council recognises the need to access expert advice on Treasury issues. The Council's advisers meet on a quarterly basis with Officers, review Enfield's current position, sets out the market conditions and economic outlook and provides professional advice that is specific for Enfield. This is in addition to being informed on live issues and newsletters.

Economic Outlook and Prospect for Interest Rate Rises

23. Interest rates have been at historically low levels for over ten years since the banking crisis and onset of austerity and there is a little prospect of an upward movement in the near term.

24. Chart 1: Interest Rate Forecasts



25. The detailed set of forecasts are set out in Appendix 2

26. Arlingclose, the Council's Treasury Advisers expect the Bank Rate to remain at the current 0.10% level over the medium term and the likelihood of a Bank Rate cut over the next three years, either to zero, or to negative rates has reduced significantly. However, significant downside risks remain – the damage from the pandemic will have lasting effects and there is the risk of further mutations due to the uneven global rollout of vaccines. Although Arlingclose do not expect negative rates, a significant mutation which was vaccine resistant, which required the creation of a new vaccine and further lockdowns could lead the UK economy into negative territory.

Consultation on the Prudential Code

27. CIPFA has recently launched a Consultation on changes to the Prudential Code, the proposals being to strengthen the provisions for borrowing. The key area being addressed is the statement that "local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed".

28. CIPFA is of the opinion that the above statement and its implications are not clearly understood. There is a proposal to change “purely” to “primarily” and to provide a few sentences of additional guidance as follows:

    i. To state clearly, that borrowing for debt for yield investment is not permissible under the Prudential Code.

    ii. Any commercial investment undertaken should be consistent with statutory provisions, proportionate to service and revenue budgets and consistent with effective treasury management practice.

29. The Consultation includes a proposal to introduce new prudential indicators on affordability including an external debt to Net Service Expenditure (NSE) ratio and a commercial income to Net Service Expenditure. There is also the introduction of the Liability Benchmark to promote good practice and understanding of local authority’s debt management in relation to capital investment.

Safeguarding Implications

30. None arising directly from this report

Public Health Implications

31. None arising directly from this report

Equalities Impact of the Proposal

32. None arising directly from this report

Environmental and Climate Change Considerations

33. None arising directly from this report

Risks that may arise if the proposed decision and related work is not taken

34. The report is for noting.

Risks that may arise if the proposed decision is taken and actions that will be taken to manage these risks

35. The report sets out the actions which are being taken to manage interest rate risk

Financial Implications

36. None arising directly from the report

Legal Implications

37. None arising directly from this report. There are, however, changes to the Prudential Code expect at the conclusion of the CIPFA Consultation which will need to be adopted in the Council’s Treasury Management Strategy when it is reviewed for 2022/23.

Workforce Implications

38. None arising directly from this report

Property Implications

39. None arising directly from this report

Other Implications

40. None.

Options Considered

41. None

Conclusions

42. Whilst interest rate movements can present a financial risk to any local authority, the Council has a number of recognised measures in place to address it – annual review of the Council's Capital investments through the Capital Programme, prudent budgeting of the interest rate used for planning purposes, active management of the profile of maturing debt and close monitoring of interest rates with the Council's Treasury adviser Arlingclose including a regular review of the economic outlook.

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Appendices

Appendix 1 – Capital Financing Costs

Appendix 2 – Interest Rate Forecasts

Background Papers

The following documents have been relied on in the preparation of this report:

Ten Year Capital Programme 2021/22 to 2030/31

Ten Year Treasury Strategy 2021/22 to 2020/31

Appendix 1

Interest and MRP Costs met by General Fund, Meridian Water and Wholly Owned Companies

	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000
Gross Interest	28,240	32,936	39,016	43,793	46,681	47,626	49,205	53,355	57,102	58,782	60,550
Debt Fees	66	125	101	85	44	45	59	96	55	49	58
Total Debt Cost	28,306	33,062	39,118	43,878	46,725	47,671	49,264	53,451	57,158	58,831	60,608
Recharges:											
Meridian Water	(8,705)	(8,838)	(8,894)	(9,314)	(9,683)	(9,900)	(10,188)	(10,144)	(9,923)	(10,098)	(10,371)
Companies	(4,240)	(4,898)	(5,315)	(6,614)	(7,745)	(7,657)	(7,567)	(7,307)	(7,150)	(7,045)	(6,937)
Joyce & Snells	0	(17)	(89)	(223)	(389)	(573)	(765)	(1,348)	(2,108)	(3,029)	(4,174)
HRA	(8,663)	(10,448)	(12,549)	(13,944)	(14,694)	(14,804)	(15,666)	(18,220)	(20,421)	(20,919)	(21,106)
Debt Fees	(32)	(60)	(43)	(40)	(3)	(6)	(22)	(60)	(17)	(16)	(23)
Interest Charged to General Fund	6,665	8,801	12,228	13,742	14,211	14,731	15,057	16,373	17,538	17,723	17,997
MRP	11,566	16,454	19,411	20,791	18,119	20,497	19,775	18,190	17,220	17,371	17,011
Total Financing Cost Charged to General Fund	18,231	25,255	31,638	34,533	32,329	35,228	34,831	34,563	34,758	35,094	35,007

Appendix 2

Interest Rate Forecasts

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Official Bank Rate													
Upside risk	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.00	0.20	0.20	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
3-month money market r													
Upside risk	0.05	0.05	0.10	0.10	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.05	0.05	0.10	0.10	0.15	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Downside risk	0.10	0.20	0.25	0.25	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40
5yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.05	0.10	0.10	0.15	0.15	0.20	0.20	0.20	0.25	0.25	0.30	0.30	0.35
Downside risk	0.20	0.20	0.25	0.25	0.35	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
10yr gilt yield													
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.40	0.45	0.50	0.50	0.55	0.55	0.60	0.60	0.65	0.65	0.70	0.70	0.70
Downside risk	0.15	0.20	0.25	0.25	0.35	0.35	0.40	0.40	0.45	0.45	0.50	0.50	0.50
20yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.85	0.85	0.90	0.90	0.90	0.95	0.95	0.95	1.00	1.00	1.00	1.00	1.00
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.45	0.50	0.50	0.50	0.50	0.50
50yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.75	0.75	0.80	0.80	0.80	0.85	0.85	0.85	0.90	0.90	0.90	0.90	0.90
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.45	0.50	0.50	0.50	0.50	0.50