
REPORT TO:	FINANCE and MANAGEMENT COMMITTEE – SPECIAL FINAL ACCOUNTS	AGENDA ITEM: 9
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REPORT FROM:	CHIEF EXECUTIVE OFFICER	OPEN
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SUBJECT:	HOUSING REVENUE ACCOUNT SELF FINANCING: TREASURY MANAGEMENT and ACCOUNTING ISSUES	REF:
WARD (S) AFFECTED:	ALL	TERMS OF REFERENCE: FM 08

1.0 Recommendations

- 1.1 That options for Debt Management are analysed and reported to the Committee in October 2011.
- 1.2 That a proposed Treasury Management Strategy is reported to the Committee in December 2011.
- 1.3 That an update on the accounting issues regarding debt management and depreciation following the publication of final guidance is reported to the Committee in October 2011.

2.0 Purpose of Report

- 2.1 To provide an update of the implications of the self-financing proposals on the Council. In particular to provide information on issues nationally and how the Council is currently, and planning to, address these issues locally.
- 2.2 This follows the announcement in February 2011 of detailed proposals relating to the abolition of the current Housing Revenue Account (HRA) Subsidy System in April 2012.
- 2.3 Eventually, the Council will need to review and update its Treasury Management Strategy and Accounting Policies to deliver the financial requirements under the new self-financing arrangements. These will be brought to the Committee for consideration and approval in October 2011.

Detail

- 3.1 On 1st February 2011 the Government issued the detailed methodology and financial parameters to be used in the implementation of self-financing for council housing. Effectively, it provided each authority with its settlement figure to move out of the housing subsidy system.
- 3.2 The proposals are currently subject to parliamentary scrutiny as part of the Localism Bill. It is expected that the Bill will receive Royal Ascent during the autumn.

Details of the Settlement

- 3.3 Each authority has been given a settlement figure to buy itself out of the national subsidy system. For authorities such as South Derbyshire who are in "negative subsidy," this one-off payment on 1st April 2012 will be in lieu of yearly subsidy payments to the Government.
- 3.4 The Government have undertaken an exercise to value the housing business at a national level and then disaggregated this for each authority. The value has been based on a set of assumptions on future costs and income and the estimated capital investment required over the next 30 years.
- 3.5 In principle, the calculation is designed to clear the outstanding housing debt nationally by allocating a proportion between authorities based on their individual valuation. In return, each authority should be in better position if the cost of servicing the debt is less than the annual subsidy payment. It should also allow an increase in resources to pay for repairs, other or new services.
- 3.6 The settlement uses the 2011/12 subsidy determination as its starting point. The key assumptions in the calculation of the debt take-on are:

- A discount rate of 6.5% for calculating the net present value of each council's housing business. This rate "discounts" the future value of the business, the higher the rate, the lower the future value with a higher payment or investment required up front to protect/achieve a future value.

The rate of 6.5% is higher than the normal rate used by the Government of 3.5% to reflect greater risks perceived around future housing costs. This reduces the future value of the business and therefore increases the overall up front payment.

- Some additional expenditure for management, maintenance and major repairs based on independent research.
- An allowance for disabled adaptations.
- An allowance for Treasury Management costs.
- 75% of net receipts from right to buy sales will continue to be paid to the Government. This was a change from original proposals and is perhaps the greatest concern to the Sector.

Both the Local Government Association (LGA) and other professional bodies continue to lobby the Government on this issue. An estimate of the loss of income from sales has been built into the valuation, but it is the loss of the capital receipt for reinvestment that gives cause for concern.

The initial Business Plan assumes that the remaining 25% remains in the HRA to fund capital investment and/or debt repayment. This would be a change in current capital policy and will need to be considered by the Committee.

- Receipts from other disposals will continue to be held locally as long as they are spent on affordable housing or regeneration. The Council will need to ensure that it has approved schemes in place in order to take advantage of this proposal.
- A cap will be placed on overall housing borrowing which will be linked to the opening debt level under self-financing.

3.7 In total, these proposals and changes have resulted in the overall debt take on at a national level increasing compared to the initial proposals published in 2010.

3.8 In addition, some policy issues were also confirmed.

- The HRA ring fence will remain and a separate balance sheet will be maintained and published for housing.
- Current social rent policy will continue with a projected rent convergence date of 2015/16. As previously reported to this Committee, due to the Council's average rent being below the national formula, convergence locally will be later.
- The Government will have the power to reopen the original settlement for changes in policy which have substantial effects on income or costs.

Timetable

3.9 The methodology for the settlement was laid out in the settlement papers but the data on which it is calculated will be updated and confirmed during 2011/12. The timescales set out by the Government is shown below.

Date	Activity or deadline
March 2011	Stakeholder events with local authorities. Local authorities planning to submit evidence on demolitions are advised to contact CLG.
June 2011	Forms sent out to collect data on stock.
August 2011	Data for self-financing provided to CLG.
August 2011 onwards	Data verified.
November	Consultation on self-financing determinations.

2011 onwards	
December 2011 onwards	CLG and PWLB issue joint letter to each local authority setting out arrangements for loans and debt redemption.
January 2012	Final self-financing determinations published. Local authorities asked to tell PWLB how much they wish to borrow.
April 2012	Series of transactions between CLG and local authorities enable the start of self-financing.
March 2013	Cut-off for final payments to end the subsidy system.

3.10 Between now and April 2012, there are several issues that authorities will need to consider and resolve. These relate to business planning, accounting and treasury management.

Business Planning

3.11 During early 2011, a working group including members and tenant representatives reviewed and updated the HRA Business Plan. This was in the light of the new self-financing system and modelled a 30-year plan based on debt take-on and future capital investment. The Plan was considered by the Housing and Community Services Committee on 16th June, with a summary report to this Committee on 23rd June.

Accounting Issues

3.12 Alongside the Government's implementation guidance the Chartered Institute of Public Finance and Accountancy (CIPFA) published a consultation paper on the capital accounting and finance arrangements under the new system. This paper covered the management of current debt and calculation of depreciation.

Management of Current Debt

3.13 Although clearly there is a strong focus on the management of substantial debt take-on under self-financing, there are prior issues around what happens to existing debt,

3.14 Authorities generally pool and manage debt centrally in the General Fund. A proportion is charged to the HRA under the subsidy system based on a consolidated rate of interest (CRI) and the HRA's underlying borrowing requirement. This mechanism will disappear in the new self-financing system.

3.15 The proportion currently charged to the HRA and then claimed back through annual subsidy will, for most authorities, not represent the actual debt attributable to the HRA. This is a historical situation due to debt being pooled and managed centrally. This is the case for South Derbyshire.

- 3.16 Authorities will now need to split out actual HRA debt on 1st April 2012 and charge this based on the actual interest rate attributable to the actual debt. Besides providing issues with splitting the debt, the change could alter the share of current debt charges that will still exist between the General Fund and the HRA on transition to the new system.
- 3.17 CIPFA's consultation paper set out to gauge the extent of the issue nationally and proposed some options for splitting debt and allocating interest payments to mitigate the impact, in particular on the General Fund. CIPFA's underlying principle is that the change to self-financing should have no detrimental impact on the General Fund.
- 3.18 The main proposal is that the existing debt pool will be split between HRA and non-HRA. The new self-financing debt will be accounted for in the separate HRA pool.

South Derbyshire's Debt

- 3.19 If a 2 pool approach is adopted and CIPFA's principle accepted, it is considered that this will be a relatively minor issue for South Derbyshire. The Council does have an underlying borrowing requirement which has been financed "internally" through its strong cash flow position as set out in the current Treasury Management Strategy.
- 3.20 However, actual debt is relatively low and easily identified. Excluding the outstanding covenants which will be repaid in full prior to April 2012, the Council's debt outstanding is a £1m market loan, together with transferred debt (£316,000 outstanding) which is managed by a neighbouring authority.

Transferred Debt

- 3.21 This relates specifically to HRA assets which were transferred back in 1974 to South Derbyshire. For administrative purposes, the debt is still managed by Erewash Borough Council. They recharge the cost of that debt each year to the Council's HRA and this is then reclaimed through the subsidy system.
- 3.22 As the debt is clearly HRA, it will be managed through the HRA pool and the cost (approximately £25,000 per year) will be accounted for in the HRA.

Money Market Loan

- 3.23 This loan was borrowed many years ago for capital expenditure. Under the current system the cost of this debt, at £48,000 per year, is effectively charged into the HRA through the current CRI calculation.

Overall

- 3.24 CIPFA's proposals will allow South Derbyshire's current debt to be easily identified and the proper proportion charged to the HRA pool. This has been reflected in the initial business plan approved by the Committee on 23rd June.

Depreciation

- 3.25 Potentially, this could be a more substantive issue. Depreciation is currently a charge in the HRA and, in the easiest sense, is the amount that is set-aside each year to pay for future capital investment.
- 3.26 Under the current system, this is paid for by the Major Repairs Allowance which is a capital allocation in the subsidy system. This is money coming back to the Authority from its negative subsidy payment, as follows:
- Negative Subsidy Calculation - £6m
 - Less MRA (Depreciation in HRA) - £2m
 - Equals Net Amount Paid to the Government in Negative Subsidy - £4m
- 3.27 In accounting terms though, the depreciation charge in the HRA becomes a notional amount as the cash is the MRA allocation. Under the new system, the Council will no longer pay over £6m (this will pay for the new debt and capital investment) but will also lose the MRA.
- 3.28 In order to provide for future capital investment and to meet accounting regulations, the HRA will need to find an equivalent sum. Simply, the approved Business Plan assumes that the current MRA amount will continue to be the depreciation and in effect this will continue to be paid into the Major Repairs Reserve to meet capital expenditure.
- 3.29 The MRA is used as a proxy for depreciation and authorities generally do not undertake a proper calculation which truly reflects the proper value and replacement cost of the housing stock. There has always been some debate amongst accounting professionals whether this is correct.

Proper Depreciation

- 3.30 As the MRA will cease to exist, effectively there will be no proxy. It is accepted that a "proper calculation" will need to be made from April 2012 and CIPFA's proposals set out some options for doing this.
- 3.31 However, the issue that is currently under debate is:
- How far will a proper calculation differ from the current MRA proxy, and
 - Will it impact upon the HRA?
- 3.32 For example, the approved Business Plan is built on the current MRA continuing to be used as a contribution to meet stock condition requirements. This is affordable within the Plan and this amount will effectively continue to be the depreciation charge.
- 3.33 Depreciation should reflect the proper economic costs of maintaining the stock over the long term. It is considered that many authorities will find that the proper calculation will be higher than what is included in their business plans as at a national level, there is evidence suggesting that current investment requirements are under funded.

- 3.34 Any additional charge, under accounting regulations, would need to be reflected in the HRA.
- 3.35 The issue is that this additional amount may not be affordable in the HRA. Therefore, discussions are on going nationally with a view to implementing regulations to “reverse out” the proper depreciation charge so that it has a neutral impact on the HRA.
- 3.36 However, this may not sit with proper accounting practice and could lead to concerns that authorities were making decisions about future capital investment with out providing sufficient resources to meet their long term requirements.
- 3.37 The Council will be undertaking a full calculation based on information contained in its latest stock condition survey.
- 3.38 Having closed the consultation period, CIPFA’s proposals are due to be reported in July 2011.

Treasury Management

- 3.39 The Council’s initial debt-take on in the settlement proposals is £54.8m. Its borrowing limit is around £9m higher at £64.2m. This limit will be fixed.
- 3.40 Therefore, on 1st April 2012 the Council will have to make a payment to the Government of £54.8m to buy-out of the subsidy system. Whether the authority borrows anything above this, up to the limit of £64.2m, is totally discretionary.
- 3.41 However, under the national prudential borrowing system, the Council would need to demonstrate that any additional borrowing can be afforded in the Business Plan. The updated Plan, recently considered by the Committee, modelled additional borrowing of around £6.5m in the early years to provide resources for additional capital improvements.

Funding Options

- 3.42 Clearly, the period prior to implementation of self financing will be used, as it is being used already, to assess the various funding options on offer. Besides the choice between fixed and variable rates, either in whole or in part, the biggest challenge will be to compare what the banks have to offer compared to the traditional funding source for local authorities, i.e. the Public Works Loan Board (PWLb).
- 3.43 This is because the increase in PWLB rates by the Government in October 2010, brought PWLB terms close to those potentially available from private sources. In addition, with a net borrowing requirement nationally of £13bn to meet the total buy-out, the Treasury have made it clear that they are not expecting the PWLB to meet the entire amount. Therefore, what are the alternatives?

Bonds

- 3.44 The Bond Market is creating a great deal of debate at present. This entails an authority (or a group of authorities) issuing bonds in the form of security guarantees to public and private investors; they in turn will buy bonds and effectively invest in the authority for a guaranteed interest return.
- 3.45 The Bond Market is used widely in the public sector in the USA, but is currently used very little in the UK. Bond issues are subject to market forces and several variables need to be considered. Authorities requiring large sums of say £100m or more are considered to be obvious candidates for bond issues.
- 3.46 Other authorities, whether in this category or not, may decide to join forces and challenge the market to respond to a funding requirement of much larger sums in the hope of securing economies of scale and a lower interest rate compared to the PWLB. However, there is complexity, administrative and cost implications to consider, in particular if authorities were to “club” together.

Credit Ratings and Legality

- 3.47 The issue on whether local authorities would need to obtain a credit rating to satisfy a bond issue is also subject to debate. Obtaining a credit rating and in particular a AAA (triple A) rating is expensive and can cost tens of thousands of pounds year on year and this would need to be balanced against achieving a preferential interest rate.
- 3.48 The introduction of the prudential borrowing regime in the Local Government Act 2003 brought with it the statutory framework for local authority funding. Sections 1 and 6 of the Act provide power to borrow for the purposes of the self-financing settlement and provide protection for funders.
- 3.49 In addition, an authority does not need to pledge physical assets (i.e. the housing stock) to secure the funding. A local authority's borrowing is secured over its revenue and Section 13 allows a funder to apply to the Court to collect the revenue to make good its losses. In short, the statutory framework provides the local authority's security in the form of a “promise or covenant” which could be considered an AAA rating.

Banks

- 3.50 An alternative to a bond issue is to borrow directly from a commercial bank. However, in the current economic climate, the banking sector may not be competitive. This is because it needs to balance making available conventional long term finance for social housing against the restrictions on realising the true capital value of the stock.
- 3.51 Banks, however, may well have an important role in addressing a potential difficulty with a bond issue, namely that it depends on market conditions “on the day.” Given the lead in time and that there is no window (entire payments need to be made on 1st April) then arrangements would need to be made to

get authorities from the transaction date to the point at which a bond issue can be safely and competitively achieved.

- 3.52 In these circumstances, it is considered that banks could provide bridging loan facilities. PWLB could also provide these facilities but they are less flexible as the PWLB do not provide loans for less than 12 months; the “bridging” period is likely to be much shorter.

Consortiums

- 3.53 Authorities are reviewing whether they should be approaching the bond market in a consortium to take advantage of their collective strength. Clearly, any joint venture requires detailed consideration of the structure, together with the benefits compared to the risks involved. It is considered that this will be magnified under self-financing.
- 3.54 It would also be important to ensure that the statutory basis (as highlighted previously) is preserved so that the AAA covenant offered by individual authorities is carried through into any consortium structure.
- 3.55 A consortium might be a purely contractual arrangement between authorities or it could be a separate vehicle. In theory, a local authority should not need a credit rating but it is considered likely to satisfy the market, in particular under a joint venture arrangement. Whether each authority would need to obtain its own individual rating or whether a collective rating would suffice, remains to be seen.
- 3.56 In any case, it is important that the Council has a strong and robust business plan to satisfy the market that the debt is serviceable and can be repaid.

Other Options

- 3.57 Authorities can borrow and lend between themselves. This may be relevant where non housing authorities such as County Councils may have finance available via their Pension Funds. Clearly, a mixture of options may also be appropriate.
- 3.58 In the shorter-term (1 to 2 years) authorities may well borrow from the PWLB and see how bond markets and other forms of borrowing evolve. Generally, PWLB will be a “safer” route, is cheaper in fees to arrange and will provide more certainty in long term borrowing costs. However, it could be more expensive compared to a competitive bond market.
- 3.59 In accordance with the implementation proposals, the Council has formally registered with the PWLB and laid down its possible requirements for next April.
- 3.60 In the meantime, a more detailed options appraisal will be undertaken and reported to the Committee in October 2011. It is expected that a revised Treasury Management Strategy will be reported for consideration in December 2011 ahead of the final settlement in January 2012.

4.0 Financial Implications

- 4.1 Detailed analysis has been undertaken in the Business Plan previously reported to the Committee. As regards treasury management, this assumed a long term interest rate of 5.75% and all debt, including that taken on with the original settlement, being repaid by Year 25 of the 30-year business plan.
- 4.2 The Plan assumes borrowing rising from the original debt settlement of £54.8m in 2011/12 to a maximum of £61.3m in 2015/16 to pay for capital investment. Debt is then repaid from 2016/17 onwards.
- 4.3 This would provide a sustainable financial position and allow for greater capital investment over and above current resources available in the subsidy system.
- 4.4 However, the treasury management assumptions can only be broad and general at this stage. Clearly, the ultimate cost of debt and how / when it is repaid will depend on actual rates and the maturity profile of the debt.
- 4.5 Currently, long-term interest rates, including those offered by the PWLB, are well below 5.75%. For example, the PWLB rate for borrowing over 20 years ranges from 4.5% to 5% depending on the repayment profile. Short-term borrowing is as low as 1.5%, although short-term borrowing needs to be refinanced on a regular basis which can be risky.
- 4.6 As highlighted previously, options will be analysed and included in a proposed Treasury Management Strategy later in the year. Current interest rates are still historically low and there is a real risk that they will rise between now and the self-financing date.

5.0 Corporate Implications

- 5.1 The Legal issues have been highlighted in the report. There are no personnel or other resource issues.

6.0 Community Implications

- 6.1 Clearly, the proposals will have a significant impact upon Tenants and representatives have been included in the Business Plan review. On-going communication with all tenants through established means will continue to provide updates and key decisions.

7.0 Background Papers

- 7.1 Implementing Self-Financing for Council Housing:

<http://www.communities.gov.uk/publications/housing/implementingselffinancing>

- 7.2 Consultation on Proposed Capital Finance Arrangements Under the New Housing Finance System:

http://www.cipfa.org.uk/pt/download/HRA_Review_Consultation_2011.pdf