Capital Strategy Report 2020/21 **Appendix C**

1. Introduction

1.1 This capital strategy gives a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services along with an overview of how associated risk is managed and the implications for future financial sustainability. It has been written in an accessible style to enhance members' understanding of these sometimes technical areas.

1.2 Decisions made this year on capital and treasury management will have financial consequences for the Authority for many years into the future. They are therefore subject to both a national regulatory framework and to local policy framework, summarised in this report.

1.3 Financing Capital expenditure is where the Authority spends money on assets, such as property or vehicles that will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. The Authority has some limited discretion on what counts as capital expenditure, for example assets costing below £10,000 are not capitalised and are charged to revenue in year.

1.4 In 2020/21, the Authority is planning capital expenditure of £319m as summarised below:

Table 1: Prudential Indicator: Estimates of Capital Expenditure in £ millions

	2018/19 actual	**2019/20 est.**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
General Fund (GF) services	97	159	180	155	36
Council housing (HRA)	35	55	139	122	70
TOTAL	**133**	**214**	**319**	**277**	**106**

The main General Fund capital projects include work on the new Town Hall, work on Liveable Streets, Carriageway, footway and street lighting improvements.

1.5 The Housing Revenue Account (HRA) is a ring-fenced account which ensures that council housing does not subsidise, or is itself subsidised, by other local services. HRA capital expenditure is therefore recorded separately.

1.6 **Governance:** Service managers submit bids in order to include projects in the Authority's capital programme. The Senior Leadership Team appraises all bids based on a comparison of service priorities and makes recommendations to the Mayor's Advisory Board. The final capital programme is then presented to Cabinet in January and to Council in February each year.

1.7 All capital expenditure must be financed, either from external sources (government grants and other contributions), the Authority's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative). The planned financing of the above expenditure is as follows:

Table 2: Capital financing in £ millions

	2018/19 actual	**2019/20 Est.**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
External sources	35	60	81	90	32
Own resources	53	69	94	73	39
Debt	45	85	144	114	35
TOTAL	**133**	**214**	**319**	**277**	**106**

1.8 Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as minimum revenue provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. Planned MRP and use of capital receipts are as follows:

Table 3: Replacement of debt finance in £ millions

	2018/19 actual	2019/20 est	2020/21 budget	2021/22 budget	2022/23 budget
Planned MRP payments	8.639	10.987	12.640	15.112	17.850

1.9 When the Council funds capital expenditure by borrowing it must put aside enough money from its revenue budget each year to repay that borrowing in later years. The amount charged to the revenue budget for the repayment of borrowing is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Authority to have regard to the Ministry of Housing, Communities and Local Government's *Guidance on Minimum Revenue Provision* (the MHCLG Guidance) most recently issued in 2018.

1.10 The broad aim of the MHCLG Guidance is to ensure that capital expenditure funded by borrowing is financed over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

1.11 The Guidance requires the Council to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance as well as locally determined prudent methods. This statement is consistent with that approved by the Council for 2019/20:

1.11.1 For supported capital expenditure MRP will be determined in accordance with the former regulations that applied on 31st March 2008, incorporating an "Adjustment A" of £17.5m. *(MHCLG Guidance Option 1 – the Regulatory Method)*

1.11.2 For unsupported capital expenditure MRP will be charged over the expected useful life of the relevant asset in equal instalments, starting in the year after that in which the asset becomes operational. There are two areas where asset lives are bound by regulation. MRP on purchases of freehold land will be charged over 50 years. MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years. *(MHCLG Guidance Option 3 – the Asset Life Method)*

1.11.3 For assets acquired by leases or the Private Finance Initiative, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability *(per MHCLG Guidance)*.

1.11.4 For loans to third parties that are required to be capitalised and are to be repaid in annual or more frequent instalments of principal, the Council will not make MRP but will instead apply the capital receipts arising from the principal repayments to finance this expenditure. In years where there is no principal repayment MRP will be charged based on the estimated life of the relevant asset. While this is not one of the options in the MHCLG Guidance, it is thought to be a prudent approach since it ensures that the capital expenditure incurred is fully financed.

1.11.5 Under the MHCLG Guidance MRP is not required to be charged in respect of assets held within the Housing Revenue Account (HRA). Following removal of the HRA debt cap by central government the Council has determined to make a Voluntary Revenue Provision (VRP) on new HRA debt funded capital expenditure. VRP is charged over the expected useful life of the relevant assets in equal instalments, starting in the year after that in which the assets become operational.

1.12 The Authority's cumulative outstanding amount of debt finance is measured by the capital financing requirement (CFR). This increases with new debt-financed capital expenditure and reduces with MRP capital receipts used to replace debt. The CFR is expected to increase by £132m during 2020/21. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Table 4: Prudential Indicator: Estimates of Capital Financing Requirement in £ millions

	31.3.2019 actual	**31.3.2020 est.**	**31.3.2021 budget**	**31.3.2022 budget**	**31.3.2023 budget**
General Fund services	288.415	337.783	388.083	422.283	415.083
Council housing (HRA)	84.903	110.810	192.091	256.926	281.369
TOTAL CFR	**373.318**	**448.593**	**580.174**	**679.209**	**696.452**

1.13 **Asset disposals:** When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets or to repay debt. The Council is currently also permitted to spend capital receipts on service transformation projects until 2021/22. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive £54m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts receivable in £ millions

	2018/19 actual	**2019/20 est.**	**2020/21 budget**	**2021/22 budget**	**2022/23 budget**
Asset sales	22	52	54	35	17
Loans repaid	0	0	0	0	0
TOTAL	**22**	**52**	**54**	**35**	**17**

2 Treasury Management

2.1 Treasury management is concerned with keeping sufficient but not excessive cash available to meet the Council's spending needs, while managing the risks involved. Surplus cash is invested until required, while a shortage of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account. The Authority is typically cash rich in the short-term as revenue income is received before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. The revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing.

2.2 Due to decisions taken in the past, the Authority currently has £73m borrowing at an average interest rate of 3.18% and £266m treasury investments at an average rate of 1.60%.

2.3 **Borrowing strategy**: The Authority's main objectives when borrowing are to achieve a low but certain cost of finance while retaining flexibility should plans change in future. These objectives are often conflicting, and the Authority therefore seeks to strike a balance between cheap short-term loans (currently available at around 0.75% and long-term fixed rate loans where the future cost is known but higher (currently 2.0 to 3.0%). There are a number of factors that the Council needs to take into accounts when setting its borrowing strategy.

2.4 The Council is significantly increasing its capital expenditure over the next 3 years; the draft capital programme is £702m over the next 3 financial years. This programme is partly funded by borrowing of £112m in the GF for 2020/21 – 2022/23 and £182m in the HRA for the same period. The rest of the programme is being funded by other sources including payments from developers (CIL and Section 106), capital receipts and revenue contributions (the HRA). However, in previous years, the capital programme has had major slippage, including in the currently year.

2.5 The Council's 2020-21 Budget Report and Medium Term Financial Strategy 2020-23 states that "a fundamental review of the provisional capital programme will be carried out over the next few months to ensure that programmes are delivering value for money and agreed outcomes for our communities and identifying where there are options to defer, reduce or delete schemes in order to minimise the requirement for prudential borrowing or allow headroom for new schemes that are currently unfunded. Outcomes from the Asset Strategy will form part of this review"

2.6 It should further be noted that a number of programmes have been identified as having a requirement to identify funding; significant additional financial resources are expected to be required to cover future anticipated costs, such as for fire safety, when the outcome of the Grenfell Inquiry is known. The Council has yet to agree a strategy to fund the 2nd 1,000 new Council homes and the impact of that needs to be assessed, alongside existing stock condition requirement.

2.7 The above increasing capital programme is taking place at a time when interest rates are stable and indeed the Bank of England interest rate may well be cut further; rates have been at historical lows for almost a decade. Interest rates reached a peak of 13.875% in the 1990s, then fell to 6% in 2000, and ranged between 6% - 3.75% from 2000 – 2007, before being cut to 0.5% in 2009. Rates have continued to hover between 0.25% and 0.75% since then.

2.8 It is proposed that the Council reviews both expenditure plans and the risks associated with interest rates over the next 3 months and develops a detailed strategy with regards to long term borrowing. This will involve the use of "trigger points" i.e. specific rates at which the Corporate Director Resources will actively consider taking out external debt in order to reduce the risk of a sharp, sudden and unexpected increase in rates.

2.9 Projected levels of the Authority's total outstanding debt (which comprises borrowing, PFI liabilities and leases are shown below, compared with the capital financing requirement (see above); as the Council is undertaking a review, for the purposes of these figures, it is assumed that no further external debt is taken out.

Table 6: Prudential Indicator: Gross Debt and the Capital Financing Requirement in £ millions

	2018/19 actual	2019/20 est.	2020/21 budget	2021/22 budget	2022/23 budget
Debt (incl. PFI & leases)	133.167	129.555	126.742	123.373	119.497
Capital Financing Requirement	373.318	448.593	580.174	679.209	696.452

2.10 Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. As can be seen from table 6, the Authority expects to comply with this in the medium term.

2.11 **Affordable borrowing limit**: The Authority is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year and to keep it under review. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

Table 7: Prudential Indicators: Authorised limit and operational boundary for external debt in £m

	2019/20 limit	2020/21 limit	2021/212 limit	2022/23 limit
Authorised limit – borrowing	421.327	525.741	658.125	679.244
Authorised limit – PFI and leases	57.266	54.453	51.084	47.208
Authorised limit – total external debt	478.593	610.174	709.209	726.452
Operational boundary – borrowing	391.327	525.721	628.125	649.244
Operational boundary – PFI and leases	57.266	54.453	51.084	47.208
Operational boundary – total external debt	448.593	580.174	679.209	696.452

2.12 **Treasury Investment Strategy**: Treasury investments arise from receiving cash before it is paid out again. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management.

2.13 The Authority's policy on treasury investments is to prioritise security and liquidity over yield that is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss. Money that will be held for longer terms is invested more widely, including in bonds, shares and property, to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds, where an external fund manager makes decisions on which particular investments to buy and the Authority may request its money back at short notice.

2.14 **Risk Management:** The effective management and control of risk are prime objectives of the Authority's treasury management activities. The treasury management strategy therefore sets out various indicators and limits to constrain the risk of unexpected losses and details the extent to which financial derivatives may be used to manage treasury risks.

3.15 **Governance**: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Finance and staff, who must act in line with the treasury management strategy approved by Council. Quarterly reports on treasury management activity are presented to the Audit Committee. The Audit Committee is responsible for scrutinising treasury management decisions.

3 Investments for Service Purposes

3.1 The Authority makes investments to assist local public services, including making loans to its subsidiaries & associates, local charities and its employees to support local public services and to stimulate economic growth In light of the public service objective, the Council is willing to take more risk than with treasury investments, however it still plans for such investments to generate a profit after all costs.

3.2 Total investment for service purposes are currently valued at £1.20m with the largest being a loan to Oxford House which is underpinned by a charge on the property.

3.3 **Governance**: Decisions on service investments are made by the relevant service manager in consultation with the Director of Finance and must meet the criteria and limits laid down in the investment strategy. Most loans and shares are capital expenditure and purchases will therefore also be approved as part of the capital programme.

4 Liabilities

4.1 In addition to debt of £130m detailed above, the Authority is committed to making future payments to cover its pension fund deficit (valued at £699m). It has also set aside £21.7m to cover risks of contract disputes, business rates appeals, repayment of contractor deposits and a range of risks for which the Council self-insures. The Authority is also at risk of having to pay for any defaults on loans by housing associations in connection with residential properties transferred to them by the Council, and the pension liabilities of Tower Hamlets Homes should the ALMO is not able to meet its pension obligations. As at 31 March 2019, the Tower Hamlets Homes pension fund had a IAS19 deficit of £7.3m. The Council has not put aside any money for these potential liabilities.

4.2 **Governance**: Decisions on incurring new discretional liabilities are taken by service managers in consultation with the Director of Finance

5 Revenue Budget Implications

5.1 Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

Table 8: Prudential Indicator: Proportion of financing costs to net revenue stream

	2018/19 actual	2019/20 Est.	2020/21 budget	2021/22 budget	2022/23 budget
Financing costs (£m)	8.2	9.3	10.5	11.3	12.7
Proportion of net revenue stream	2.5%	0.59%	3.14%	3.51%	3.89%

5.2 **Sustainability**: Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend for up to 50 years into the future. The Director of Finance is satisfied that the proposed capital programme is prudent, affordable and sustainable because a detailed independent assessment has been made of the costs of borrowing in future years.

6 Knowledge and Skills

6.1 The Authority employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Director of Finance is a qualified accountant with 28 years' experience; The Council pays for junior staff to study towards relevant professional qualifications including CIPFA.

6.2 Where Authority staff do not have the knowledge and skills required use is made of external advisers and consultants that are specialists in their field. The Authority currently employs Arlingclose Limited as treasury management advisers and Savills as property consultants. This approach is more cost effective than employing such staff directly, and ensures that the Authority has access to knowledge and skills commensurate with its risk appetite.