Capital Strategy Report 2021-22 **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 some of these 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 2021-22, the Authority is planning capital expenditure of £351m as summarised below:

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

Capital Expenditure	2019-20 Actual	2020-21 Estimate	2021-22 Forecast	2022-23 Forecast	2023-24 Forecast
Non-HRA	**128.144**	**119.390**	199.192	**128.691**	**67.588**
HRA	**57.121**	**77.401**	151.601	**79.494**	**-**
Total	**185.265**	**196.791**	**350.793**	**208.185**	**67.588**

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:** Following an officer process, taking account of service priorities, recommendations are made to the Mayor's Advisory Board. The final capital programme is then presented to Cabinet in January and to Council in February/March 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

	2019-20 Actual	2020-21 Estimate	2021-22 Budget	2022-23 Budget	2023-24 Budget
External sources	54.257	52.671	109.497	81.722	29.746
Own resources	63.511	67.526	82.444	49.235	3.942
Debt	67.497	76.594	158.853	77.228	33.900
TOTAL	**185.265**	**196.791**	**350.793**	**208.186**	**67.588**

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

	2019-20 Actual	2020-21 Estimate	2021-22 Budget	2022-23 Budget	2023-24 Budget
Planned MRP payments	11.000	11.875	13.444	16.324	20.830

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.

Minimum Revenue Provision (MRP) Policy Statement

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 £145m during 2021-22. 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

	2019-20 Actual	**2020-21 Estimate**	**2021-22 Budget**	**2022-23 Budget**	**2023-24 Budget**
General Fund services	303.597	338.423	401.563	433.151	451.718
Council housing (HRA)	108.394	138.286	220.555	249.871	244.375
TOTAL CFR	**411.991**	**476.709**	**622.118**	**683.022**	**696.093**

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 is only anticipating to receive HRA capital right to buy receipts from 2021 onwards as shown in the table below:

Table 5: Capital receipts receivable in £ millions

	2019-20 Actual	2020-21 Estimate	2021-22 Budget	2022-23 Budget	2023-24 Budget
Asset sales	45.024	6.000	6.000	6.000	6.000
Loans repaid	-	-	-	-	-
TOTAL	**45.024**	**6.000**	**6.000**	**6.000**	**6.000**

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 As at 31 December 2020, the Authority had £72m of borrowings at an average interest rate of 3.12% and £234m of treasury investments at an average rate of 1.01%.

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 0.065% - 0.20%) and long-term fixed rate loans where the future cost is known but higher (PWLB certainty rates currently range from 0.67% to 1.71%). There are several factors that the Council needs to consider when setting its borrowing strategy.

2.4 The Council is significantly increasing its capital expenditure over the next 3 years; the provisional capital programme is £627m over the next 3 financial years. This programme is partly funded by borrowing of £150m in the General Fund for 2021-24 and £120m 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 above increasing capital programme is taking place at a time when interest rates are historically low and indeed the Bank of England may well cut the interest rate further to zero or negative; 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 fallen further to 0.1% since then.

2.6 It is proposed that the Council reviews both expenditure plans and the risks associated with interest rates over the next 3 months on an ongoing basis 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.

2.7 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. 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

	2019-20 Actual	**2020-21 Estimate**	**2021-22 Budget**	**2022-23 Budget**	**2023-24 Budget**
Debt (incl. PFI & leases)	195.634	201.153	277.825	190.654	142.150
Capital Financing Requirement	411.991	476.709	622.118	683.022	696.093

2.8 Statutory guidance is that debt should remain below the capital financing requirement, except in the short-term. Table 6 above demonstrates that the Authority expects to comply with this in the medium term.

2.9 **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

	2020-21 Limit	**2021-22 Limit**	**2022-23 Limit**	**2023-24 Limit**
Authorised limit – borrowing	450.871	599.649	664.429	682.026
Authorised limit – PFI and leases	55.838	52.469	48.593	44.067
Authorised limit – total external debt	**506.709**	**652.118**	**713.022**	**726.093**
Operational boundary – borrowing	420.871	569.649	634.429	652.026
Operational boundary – PFI and leases	55.838	52.469	48.593	44.067
Operational boundary – total external debt	**476.709**	**622.118**	**683.022**	**696.093**

2.10 **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.

2.11 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.

2.12 **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.

2.13 **Governance**: Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Corporate Director Resources and staff, who must act in line with the treasury management strategy approved by Council. The Audit Committee is presented with mid-year and outturn reports on treasury management activities. 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 protect the real term value of the Council's financial assets.

3.2 Total investment for service purposes are currently valued at £1.80m with the largest being loans to Oxford House and the Davenant Centre.

3.3 **Governance**: Decisions on service investments are made by the relevant service manager in consultation with the Corporate Director Resources 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 £201m detailed above, the Authority is committed to making future payments to cover its pension fund deficit (valued at £424m). 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 not be able to meet its pension obligations. As at 31 March 2020, the Tower Hamlets Homes pension fund had an IAS19 surplus of £5.2m. 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 Corporate Director Resources.

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

	2019-20 Actual	2020-21 Estimate	2021-22 Budget	2022-23 Budget	2023-24 Budget
Financing costs (£m)	8.7	17.1	19.7	26.8	32.1
Proportion of net revenue stream	2.06%	3.82%	4.30%	6.02%	7.04%

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 Corporate Director Resources 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 Interim Corporate Director Resources is a qualified accountant with over 30 years' experience and 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.