AGENDA ITEM NO 9

REPORT NO 104/22

ANGUS COUNCIL

ANGUS COUNCIL – 10 MARCH 2022

REVIEW OF LOANS FUND POLICY

REPORT BY THE DIRECTOR OF FINANCE

ABSTRACT

This report introduces a revised policy on Loans Fund debt charge repayment profiling following a review of the current repayment profiling methodology. The objective of the revised policy is to support a sustainable and deliverable longer-term revenue budget strategy, whilst ensuring that provision remains prudent and appropriate to the benefits that are provided from the associated capital expenditure.

1. RECOMMENDATION(S)

1.1 It is recommended that the Council:

(i) approves the amended Loans Fund repayment policy from 2021/22 onwards that incorporates the changes outlined in this report as summarised in Section 5;

(ii) approves the amended loans fund advances repayment mechanism and resultant debt charges profile for current and future loan repayments as summarised in Section 6; and

(iii) notes that this will generate the £2m target of savings within the capital financing costs budget from 2021/22 as provided for in the Council's Change Programme.

2. ALIGNMENT TO THE COUNCIL PLAN / COMMUNITY PLAN

2.1 Effective treasury management maximises the resources available to the Council to provide services. The activities undertaken through the Council's treasury management processes within the framework of the Treasury Management Practices therefore contribute as a whole to the local outcomes contained within the Council Plan.

3. BACKGROUND

3.1 When the Council incurs capital expenditure, for example to build a new school, some or all of that expenditure will be paid for by borrowing to spread the cost. This makes capital projects more affordable but is also appropriate accounting practice in a local government context because the repayment of the amounts borrowed should be matched to the period over which the asset will provide benefit to the community.

3.2 The Council uses an internal Loans Fund for borrowing purposes. The Loans Fund acts as an internal bank by borrowing externally from e.g. the Public Works Loans Board, to bring in the funds required and then lending those funds internally to Council services to undertake their capital projects. That internal lending from the Loans Fund is called a loans fund advance. Repayment of loans fund advances (the principal) along with interest costs and Loans Fund expenses are charged to the Council's revenue budget each year against the budget called Loan Charges or Capital Financing Costs. The period over which a loans fund advance is repaid has a significant financial impact, for example £10 million repaid over 10 years (on an equal instalments of principal basis) would require a charge to the revenue budget of £1 million per annum whereas repayment of the advance over 50 years would require a charge of only £0.2 million per annum.

3.3 This report proposes changes to the Council's existing policy for the repayment of loans fund advances made possible by a change in regulations.

3.4 The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 came into effect on 1 April 2016, replacing the statutory provisions for local authority borrowing, lending and loans fund as set out in Schedule 3 of the Local Authority (Scotland) Act 1975.

3.5 The 2016 regulations have changed the basis on which the loans fund is accounted for. It has moved them from a prescriptive basis on how repayment values are to be calculated, to one based on prudent principles. Each local authority is now provided with the ability to determine what they deem to be prudent. These changes in regulations have brought in more flexibility for local authorities to apply a prudent provision and support changes to future payments to repay the outstanding loans fund advances over a different period, providing it can be considered as prudent to do so. Lengthy discussions between Councils, Scottish Government officials and Audit Scotland in relation to the application of the 2016 Regulations took place so it took some time to confirm that proposals such as those set out in this report were available to Councils to apply.

4. REGULATORY CHANGES

4.1 From 1 April 2016 the statutory purpose of the loans fund is simplified as follows:

- to recognise, by making advances from the loans fund, the expenditure incurred, or loans made to third parties, by the authority, which a local authority has determined are to be financed by borrowing;
- to record transactions – opening balances each year, new advances, repayments charged to revenue (statutory repayment of debt), and a closing position balance at each financial year end, being the value of loans fund advances still to be repaid / charged to revenue;
- for each loans fund advance made, to record the annual repayment to be made to revenue. This will provide an authority with a profile of annual charges representing the amount of statutory repayment of debt to be charged to the General Fund / Housing Revenue Account in any financial year.

4.2 The new regulations require a local authority to determine for each loans fund advance:

- the period over which the advance is to be repaid to the loans fund;
- the amount of repayment to be made to the loans fund in each financial year in that period.

4.3 The aim of a prudent repayment is to ensure that the repayments of a loans fund advance, in relation to the repayment period and each year's repayment amount, are reasonably commensurate with the period and pattern of the benefits provided from the capital expenditure supported by the loans fund advance. This is an important point to consider in the judgement and application of what is prudent. Broadly speaking there is a need to ensure that the cost of creating an asset (funded through a loans fund advance) is paid for over a period commensurate with the life of that asset. This ensures current and future taxpayers aren't paying too much or too little for the benefits of that asset over its lifetime.

4.4 The 2016 changes of the legislation enacted were to simplify the loans fund administration and provide local authorities with flexibility to determine the repayments of loans fund advances. Both primary and secondary legislation confirms subsequent variation is allowable if the local authority considers it prudent to do so. These flexibilities within the legislation enable Angus Council to make the most appropriate choices for its own situation and circumstances as long as it can demonstrate that any change in policy is prudent.

4.5 There are provisions within the Statutory Guidance which provide options on its application. However, neither the guidance nor legislation defines what is prudent. It is therefore for each local authority to manage this appropriately and to determine prudent repayment based on its own individual circumstances. These changes in regulations have brought in more flexibility for local authorities to apply a prudent provision and support changes to future payments to repay the outstanding Loans Fund advances over a different period if it can be justified as prudent to do so. This is very much a matter of professional judgement for the S95 Officer (Director of Finance).

5 REVIEW OF LOANS FUND

5.1 A review of the Council's loans fund repayment policy has been undertaken by the Council's treasury advisors, Link Group have advised many Scottish Councils in relation to this matter. The objective of the review was to examine whether the Council's existing repayment policy for loans fund advances remained suitable and to explore options which could reprofile the loans fund repayments in order to assist with the delivery of a sustainable and deliverable longer term revenue budget strategy, whilst ensuring that the provision remains prudent and appropriate to the benefits that are provided from the associated capital expenditure. As well as determining an appropriate policy from 2021/22 onwards the review has also looked at the impact of applying that policy retrospectively. Retrospective application of the policy results in financial savings to the Council if previously applied repayments of loans fund advances are assessed as having been higher than is necessary to ensure a prudent approach.

5.2 In considering the most appropriate options for the Council, Link Group has not specifically applied any of the options set out in the statutory guidance but has instead had regard to the guidance in terms of taking a balanced view by considering the complete provisions on the overriding principles of prudence, financial management and financial sustainability of the Council.

5.3 Link Group concluded their initial review in 2020/21 and provided officers with a draft report. The application of the review findings (in particular the phasing of the savings) still requires to be finalised. The Director of Finance recommended that finalising the loans fund review (originally intended to be implemented in financial year 2020/21) be deferred to financial year 2021/22. This deferral allowed the council to conclude that it would not implement the COVID-19 fiscal flexibilities (report 72/21 refers) prior to implementation of the savings from the Loans Fund Review. As a result of this deferral, Link Group's initial review was updated during 2021/22 to take account of the loans fund position on 31 March 2021 and extracts of it are attached and referred to later in this report.

Loans Fund Advances

5.4 Loans fund advances are the capital investment funded by borrowing and are split between the General Fund and Housing Revenue Account loans. As at 31 March 2021, the total amount outstanding for Angus Council was £138.878 million, split £109.241 million for General Fund and £29.637 million for Housing Revenue Account. After removing the prudential borrowing of £3.615 million (self-funded borrowing undertaken by services), the General Fund amount is reduced to £105.626 million.

5.5 These amounts outstanding exclude loans fund advances relating to the former Tayside Police and Housing Associations. This is because the annual loan charges associated with this debt are not met from the corporate loan charges budget.

Loans Fund Repayments

5.6 The repayment of loans fund advances is based on:

- the period set for which each advance is to be repaid to the loans fund; and
- the annuity interest rate (the method used which links the repayment of the borrowing to the flow of benefits from an asset where the benefits are expected to increase in later years).

5.7 The statutory guidance identifies that the broad aim of a prudent repayment is to ensure that the repayments of a loans fund advance, in relation to the repayment period and each year's repayment amount, are reasonably commensurate with the period and pattern of the benefits provided to the community from the capital expenditure.

5.8 The method advised by Link Group as the most appropriate for Angus Council is a simplified annuity method that uses an average repayment period for all loans fund advances and reflects the prudence requirement as stated above, i.e. that it is commensurate with the benefits provided by the capital expenditure.

5.9 The statutory duty to administer the loans fund in accordance with prudent financial management extends to the interest rate selected for the annuity calculation. The statutory guidance does not advise on what is an appropriate interest rate for the annuity but suggests that a local authority should set out their policy on interest rate selection and apply that policy consistently.

Period of Repayment

5.10 When preparing the annual accounts, the asset lives in respect of the main categories where borrowing is undertaken for capital investments is broadly based on Finance Circular 29/1975 from the former Scottish Office, which detailed maximum periods for the repayment of loans fund advances.

5.11 Some of the current loan repayment periods are shorter or longer than their asset lives. Loan advance repayments should be profiled over a period which reasonably reflects the period of the economic benefit of the asset. To profile over a shorter period could be deemed imprudent as it could be viewed as requiring the taxpayer to repay capital investment before receiving the full benefit from the asset. Conversely, profiling over a longer period could mean that taxpayers are not repaying the full capital investment before the asset's life has ended.

5.12 Link Group have based their review on repayment periods of 35-45 years for both the General Fund and the HRA. The review confirms that the Council has charged more to its revenue budget in past financial years than would be strictly necessary to deliver a prudent repayment profile under the 2016 Regulations and this means a saving can be generated through retrospective reprofiling of repayments.

5.13 After reviewing the General Fund and HRA options set out in the Link Group report officers have concluded that a 40 year period option should be applied as this period is in line with the Council's recognised assets lives and broadly reflects the period over which the benefits from the capital expenditure are provided to the community. It is proposed that this is used as the write off period for future loans fund advances to simplify administration of the loans fund. A 40 year period is considered to be prudent bearing in mind the Council funds shorter life assets such as vehicles and equipment through prudential borrowing by services (i.e. not as part of the Council's main loan charges budget) and therefore loans fund advances will in the main be for longer life assets.

<u>General Fund</u>

5.14 As outlined in paragraph 5.12 a saving is available to the Council from retrospective reprofiling of loans fund advances. How the Council applies that saving is a matter of choice but the need for a prudent approach remains paramount. After considering the 40 year options in the Link Group report officers recommend that the option which excludes Prudential borrowing of £3.615 million and delivers a £2 million p.a. saving should be applied. This will give General Fund savings smoothed to £2 million for as long as possible i.e. up to and including financial year 2042/43 (see Appendix A). This approach allows the Council to safely apply the previously planned for saving of £2m from the Loans Fund Review to its base budget because that saving is assured for the long term.

<u>HRA</u>

5.15 After considering the 40 year options in the Link Group report officers recommend that the option which gives HRA savings smoothed to £0.5 million p.a. should be applied. This would allow those savings to be applied for as long as possible i.e. up to and including financial year 2033/34 (see Appendix B).

Annuity Interest Rate

5.16 The annuity interest rate currently used to calculate principal repayments is 8.50%. A higher annuity rate has the impact of lower principal repayments in the earlier years and higher principal repayments in the later years and vice versa for a lower annuity rate.

5.17 Link Group's analysis of the historic loans fund interest levels actually applied by the Council demonstrate a weighted average of 4.92% over the General Fund and Housing Revenue Account. For simplicity of future application, the review recommends the amendment of the Council's annuity rate to 5%. Once calculated it is only the principal element of the calculation that represents the annual repayment of loans fund advance. Based on Link Group's recommendation, it is proposed that an annuity interest rate of 5 percent is deployed from 2021/22 onwards by the Council.

Variation of Prior Year Repayments

5.18 The 2016 Regulations stipulate that a local authority may subsequently vary either the period or the amount of repayment (or both), if it considers it prudent to do so. Given the outcome of the review above, it is appropriate to revise the prior year repayment methodologies to ensure consistency and prudence going forward.

Summary Of Loans Fund Policy Proposals

5.19 Set out below is a summary of the proposals for amendment of the Council's policies in relation to management of the loans fund. In light of the review undertaken by Link Group and the consideration of this by officers:-

- Repayments: change from a specific write off period for each advance to one of 40 years for all advances;
- Annuity Interest Rate: change from a 8.5% to 5% rate for future loans fund advances;
- Loans fund debt at 31 March 2021: the above noted repayment and annuity interest rates are applied.

6 FINANCIAL IMPLICATIONS

6.1 The corporate loan charges budget meets the costs associated with loans fund advances – principal, interest and expenses. In anticipation of the financial benefit that the changes in the regulations would facilitate, a saving in the corporate loan charges budget of £2.0 million was included in the Council's Change Programme for 2020/21. The deferral of the Loans Fund Review, noted earlier in this report, resulted in a savings shortfall in the 2020/21 revenue budget. This was addressed, on a one-off basis, through approval to limit the use of the special repayment strategy (£1.5 million) and use of uncommitted Reserves of £0.5 million.

6.2 Applying the methodology outlined in Section 5 to the loans fund advances outstanding as at 31 March 2021 will have the following effect on the loan charge principal repayments over the period 2021/22 to 2025/26, as detailed in table 1 below.

Table 1 – Revised Loan Charges Over Next 5 Years (table has 7 columns and 7 rows)

Row		General Fund			Housing Revenue Account		
1	Year	Current Estimate £m	Revised Estimate £m	Saving £m	Current Estimate £m	Revised Estimate £m	Saving £m
2	2021/22	6.5	4.5	(2.0)	1.7	1.2	(0.5)
3	2022/23	7.0	5.0	(2.0)	2.0	1.5	(0.5)
4	2023/24	7.3	5.3	(2.0)	2.3	1.8	(0.5)
5	2024/25	7.1	5.1	(2.0)	1.1	0.6	(0.5)
6	2025/26	7.5	5.5	(2.0)	1.2	0.7	(0.5)
7	TOTAL	35.4	25.4	(10.0)	8.4	5.9	(2.5)

End of table

6.3 Appendix A (General Fund) and B (HRA) attached provide a schedule of loans fund repayments comparing the results using the current methodology and the revised methodology over the lifetime of current debt. Ultimately the same amount of loan advance is repaid over the whole period albeit these have differing cash flows. In recognition of this a discounted cash flow exercise has been undertaken by Link Group to compare these differing cash flows. It may be noted that this analysis demonstrates a positive payback over the lifetime of our current debt for both the HRA (£1.936m) and General Fund (£13.999m). This supports the view that the proposals are prudent in line with the 2016 Regulations requirements.

6.4 The proposals contained in this report for the amendment of the Council's methodology in relation to loans fund advances is considered to provide a more consistent debt repayment and represents a prudent approach.

7. EQUALITY IMPACT ASSESSMENT

7.1 An Equality Impact Assessment is not required.

NOTE: No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973, were used in the preparation of this report.

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List of Appendices:
Appendix A – General Fund Nominal and Net Present Value Savings
Appendix B – Housing Revenue Account Nominal and Net Present Value Savings