REVIEW OF
CAPITAL SPENDING PLANS
TREASURY MANAGEMENT STRATEGIES
DEBT CHARGES AND BORROWING

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1. Introduction and Summary

In July 2022, Worth Technical Accounting Solutions Limited was engaged by the London Borough of Croydon ("the Council") to review the Council's Treasury Management Strategies and capital spending plans as part of its ongoing "Opening the Books" review. Our work also compared the Council's current borrowing levels and spending plans with other London authorities.

Our initial review was carried out in July and August 2022, and this report sets out our findings and recommendations at that time. In summary, we identified that:

- The process for prioritising capital expenditure and in particular for revisiting planned capital expenditure in the light of the Council's current financial challenges needs to be reviewed. Restricting future levels of capital expenditure to essential items only would reduce pressure on future revenue budgets in terms of both debt charges and premises costs
- The Council should also take steps to reduce its dependence on borrowing to fund capital investment, by identifying sources of non-government grant funding, and generating additional capital receipts from asset sales,
- Although the Council had recently implemented an asset disposal strategy, this could be much more ambitious and there is scope to use capital receipts from sales of operational assets to reduce loan borrowing, fund recent Capitalisation Directions from the Government, and finance essential capital spending plans
- Historic reliance on external borrowing to fund ambitious capital spending plans means that the Council now has significantly higher levels of external loan debt than other London authorities. High levels of short term, variable rate borrowing represent a particular risk given expected increases to interest rates over the next 2-3 years. Driving down borrowing and interest charges should be a key priority for the Council.
- Current capital spending plans, treasury management and investment strategies do not meet CIPFA and Government guidance. These are key policy documents which need to be more transparent about future capital spending plans, how these plans will be funded, and the potential impact of current spending plans on revenue budgets going forward.
- Investment strategies and out-turn reports should set out actual and expected returns for all types of investment activities, including commercial property, council-owned companies, and third-party loans.
- MRP policies needed to be reviewed, to ensure that they reflected current Government guidelines and were consistently reflected in both detailed calculations and budget reports.

Since our initial review, the Council has taken steps to review both MRP calculations and its capital investment plans. Elected members have also approved much more ambitious asset disposal plans, in order to reduce premises costs and to generate additional capital receipts.

2. Capital spending plans

1. CIPFA's Prudential Code and Treasury Management Code require local authorities to publish both a capital strategy and a capital budget, following their approval by elected members at the start of each financial year. Both documents are considered in turn below.

2. The purpose of the capital strategy is to set out the long-term context within which investment decisions are made, giving due consideration to risk, reward, and the Council's priorities. The Council's Capital Strategy is set out in Appendix A of the Treasury Management Strategy (TMS), but at only two pages long this falls well short of the expectations set out in the Prudential Code. CIPFA have published Guidance on drafting the capital strategy which includes worked examples. Two good examples in London are Waltham Forest and Westminster, see links below:

   LB Waltham Forest Capital Investment Strategy 2021/22 to 2026/27

   Westminster City Council Capital Strategy 2022/23 to 2026/27

3. The purpose of the capital programme is to set out in more detail the major items of investment planned for each financial year, alongside expected cost and anticipated funding. Para 54 of the Prudential Code requires local authorities to report an estimate of the total capital expenditure for the current year and forthcoming next two years.

4. The Council did prepare a 3-year rolling programme for General Fund and HRA capital budgets in 2021. This covered the period from 1 April 2021 to 31 March 2024 and was approved by Full Council on 8 March 2021. Two points arise:

   - Whilst the three-year programme reported meets the minimum requirements of the Prudential Code, many local authorities operate a 5-10 year planning horizon; and

   - Although the 2022/23 TMS refers to a revised capital programme, it is not clear how (or when) these changes were approved by elected members as an updated capital programme was not presented to either Cabinet or Full Council alongside the 2022/23 revenue budgets and TMS in March 2022.

5. The HRA Business Plan approved by Cabinet on 21 March 2022 does however include a one-year budget for capital works of £23.6m. This is a reduction of £3.3m (over 12%) compared to the original budget of £26.9m approved in March 2021. At c2% of the net book value of Council dwellings, the revised budget represents a relatively low level of investment in the housing stock – at many other councils this figure would be between 5% and 10%. Although we understand that most of the housing stock already meets the Decent Homes Standard, lower capital investment at this stage may lead to pressure on HRA repairs and maintenance budgets in future years.

6. As discussed above, the status of the 2022/23 General Fund capital programme at the time of our initial review was not clear, however information presented to members in the 2022/23 TMS suggested a significant increase in planned capital spending.

7. It was not clear from our review of Cabinet reports how capital spend is prioritised or whether projects previously approved by members have been revisited in view of the Council's current financial position. For example:

- we were not clear about whether the spending controls which were initiated following the s114 notice are being applied to capital as well as revenue spending.
- many local authorities operate "gatekeeping" systems whereby proposals for new capital projects are prioritised based on value for money, potential for revenue savings or contribution to Council priorities.
- one Council currently in receipt of exceptional financial support is specifically restricting capital expenditure to essential maintenance works and grant-funded projects only. Another restricts borrowing to essential capital works.

8. As the Council is currently facing exceptional financial challenges, a significant increase in spending on new capital projects at this time would not be expected.

9. Historically, the Council's General Fund capital investment programme has largely funded from external or unsupported borrowing. However, the Council has recently approved a more ambitious asset disposal strategy aimed at realising capital receipts to:

- fund capital investment,
- repay loan debt,
- finance Capitalisation Directions, and
- finance capitalised Transformation costs.

10. Looking forward, the 2023/24 Treasury Management Strategy should be consistent with this new asset disposal strategy and clear about the intended use of future capital receipts income. It should also set out clearly the risks associated with any failure to generate expected asset sales and the assumptions underpinning expected capital funding streams.

11. Currently, all of the assumed grant funding in capital spending plans is expected to come from central government and there is no evidence of the Council successfully accessing funds from other funding agencies or charitable trusts. Many local authorities would expect a significant proportion of capital funding to come from these sources and devote considerable staff resource to identifying suitable projects and bidding for available funds. Alternatively, other councils have a policy of supporting community groups to access project-based funding not available to local authorities.

Recommendations

R1. The Council should develop a Capital Strategy in line with the current requirements of CIPFA's Prudential Code. This Strategy should clearly set out how capital investment is prioritised and include a requirement for projects previously approved by members to be revisited in the light of the current financial position.

R2. An updated version of the rolling three-year capital programme should be presented to members for approval as part of 2023/24 budget reports.

R3. The Council's TMS should set out the assumptions and key risks underpinning expected changes to capital funding streams.

R4. The Council should aim to reduce its dependence on borrowing to fund capital investment, by:

- **identifying sources of non-government grant funding, and**
- **generating additional capital receipts from asset sales.**

3. Treasury Management Strategies (TMS)

1. Treasury Management Strategies should bring together all of the Council's non-revenue spending plans and should explain, clearly and unambiguously, how these plans are to be financed, and the ongoing revenue implications of these plans.

2. The TMS needs to be consistent with the capital programme and capital strategy approved by elected members, to ensure that:

   - legislative capital financing requirements are complied with,
   - key financial indicators (Prudential Indicators) are correctly calculated, and
   - financial resources are available to fund capital investment as and when required.

3. We have already highlighted that the 2022/23 TMS seems to include some changes to Council's capital spending plans not separately approved by members. We also identified some inconsistencies within the 2022/23 TMS itself.

4. Potentially these discrepancies mean that the Council's CFR and Key Prudential Indicators may be incorrectly calculated. This creates a risk that the Could be over-borrowing and may not be able to afford increased debt charges as a result.

5. There are no performance indicators included in the 2022/23 TMS for any of the Council's commercial and equity-based investments which currently include the following:

   - a £99m investment property portfolio,
   - £175m of loans to third parties,
   - council-owned companies, which were reporting a net loss of £1.9m at 31/3/2021 according to Group accounts,
   - investment in the Real Lettings Property Fund, currently valued at £48m.

6. The DCLG Statutory Guidance on Local Government Investments (3rd edition published in February 2018) draws a clear distinction between treasury management investments and other investments, but paragraph 22 of the Guidance requires local authorities to:

   - disclose the contribution that all non-treasury investments make towards service delivery and financial objectives, and
   - develop and report on a range of indicators to explain performance for each type of investment and the extent of any additional debt costs taken on.

7. The non-treasury investments listed in above total £322m which is significant to the Council. The TMS should therefore include clear performance targets for each type of non-treasury investment covering security, liquidity and yield.

Recommendations

R1. Information contained within the TMS and used to calculate key prudential indicators should be consistent internally and with revenue budgets and capital spending plans approved by Full Council.

R2. The TMS should include up to date financial information and clear performance targets for all types of treasury and non-treasury investments in terms of security, liquidity and yield. For example:

- **regarding loans to third parties, security arrangements, due diligence processes, and the arrangements in place for monitoring repayment and assessing the possibility of default**

- **regarding investments in council companies, the arrangements for managing performance against financial and non-financial targets, and agreed exit strategies for non-performing companies**

4. Debt charges and borrowing

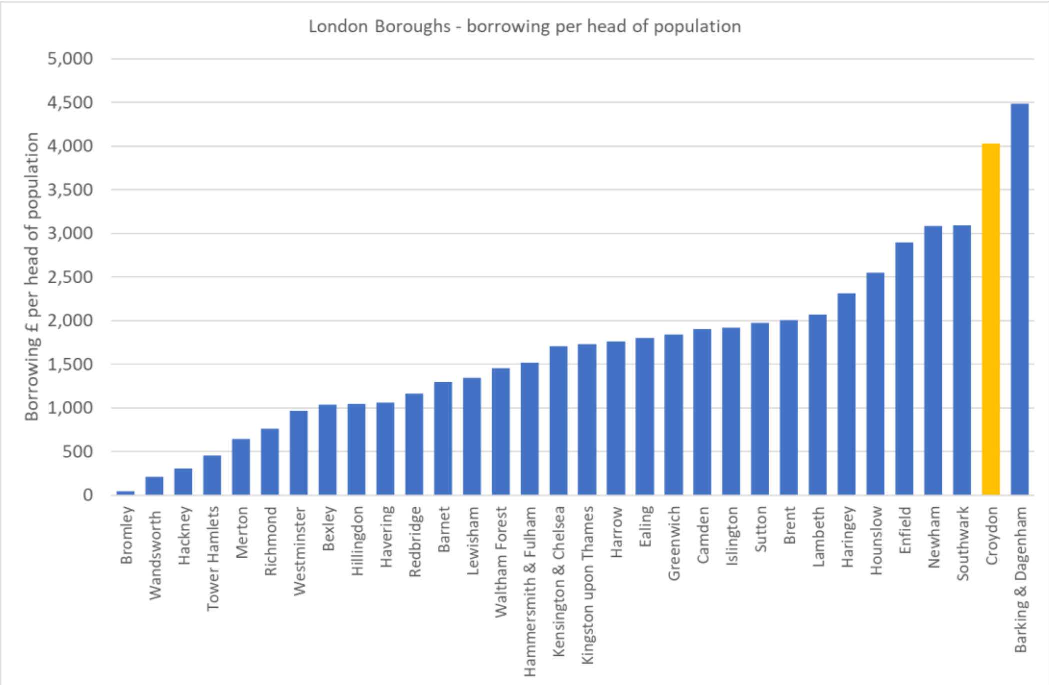
1. The Prudential Code requires affordability of borrowing to be measured in terms of overall borrowing levels, borrowing risk and total debt costs, comprising both interest charges and, where relevant, any amounts set aside for MRP (see below).

2. The Prudential Code also requires each local authority to operate within borrowing limits approved by members. The Council has recently increased its operational debt boundary to £1,637m and expects to be within 5% of this limit by 31 March 2025, as shown below:

	2020-21 £m	2024-25 £m	
Total expected borrowing	1,445	1,561	8% increase over 4 years
Borrowing for non-op purposes	99	94	remains stable at 6-7%
Operational debt boundary	1,520	1,637	actual borrowing = 95% of debt boundary
Authorised debt limit	1,570	1,687	actual borrowing = 92% of debt boundary

Source: Published TMS for 2022/23

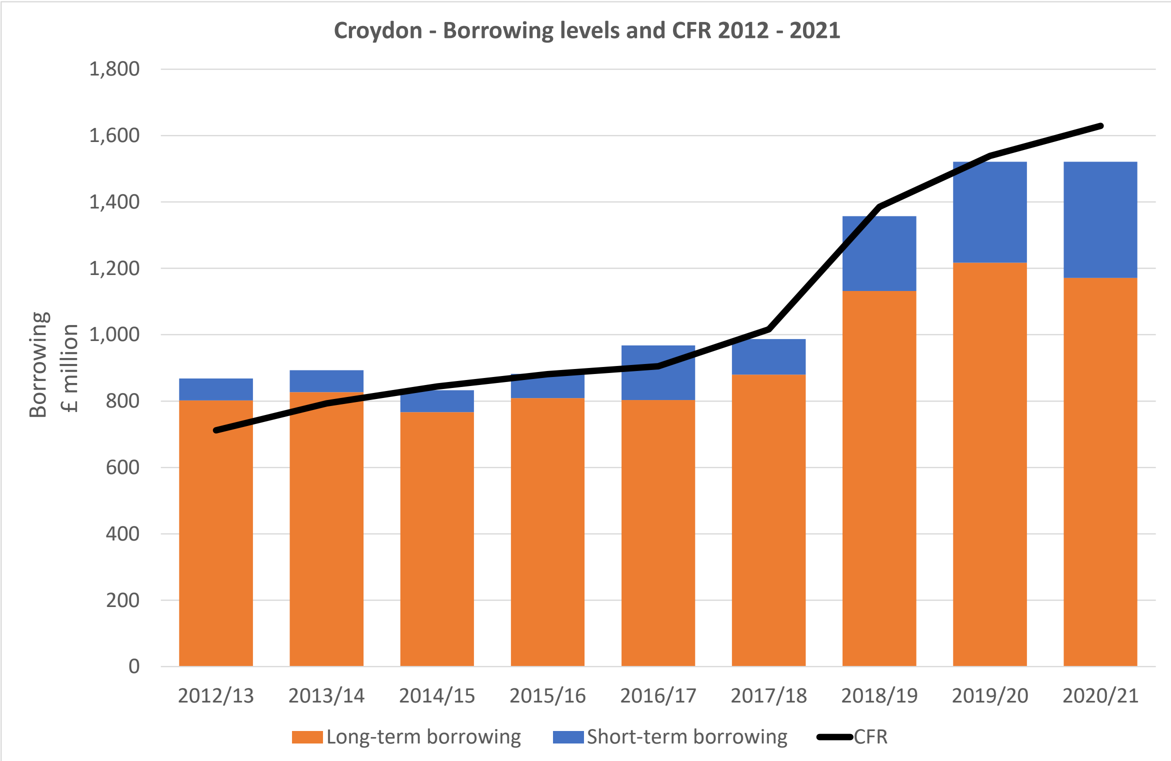
3. The Council has significantly increased its borrowing levels in recent years and now has the second highest level of borrowing per head of population in London:



Source: Published Statement of Accounts 2020/21

4. As well as the operational debt boundary, which measures borrowing in absolute terms, the Capital Financing Requirement (CFR) is another key indicator of financial resilience as it measures changes in the Council's underlying need to borrow over time. Key requirements of the Prudential Code are that external borrowing remains below the CFR overall, and that CFR calculations are based on the Council's year-end Balance Sheet.

5. The graph below confirms that in recent years the Council has been meeting these requirements. Total borrowing has been less than the CFR each year since 2018, and the CFR at 31 March 2021 reconciled to the Balance Sheet to within 1%.



Source: Published Statement of Accounts

6. However, the Council's CFR:

- is significantly higher than the other London boroughs,
- has increased from £710m to £1,630m between 2013 and 2021, and
- is expected to increase to c£1,750m by 2025.

7. This expected increase would reflect a 150% increase in borrowing in less than 10 years. Other local authorities experiencing significant financial difficulties have implemented debt reduction strategies as part of their DLUHC recovery plans. By implementing a more pro-active asset disposal strategy, capital receipts could then be used to reduce borrowing and debt charges.

8. The projected increase in borrowing of c£120m between 2021 and 2024 is consistent with the amended capital spending plans set out in the 2022/23 TMS. However, a £120m increase in external borrowing is not consistent with the expectation, set out in Appendix D of the TMS, that the ratio of financing costs as a percentage of the total revenue stream will remain stable at around 13% for the HRA, and reduce from 13% to c10% for the General Fund.

9. Financing costs as a percentage of the General Fund revenue budget will only reduce if a significant proportion of the capital programme is financed from the Council's own existing cash resources instead of new loan debt. This is sometimes referred to as unsupported or internal borrowing. Given however that the total of short-term investments and cash balances in the Council's Balance Sheet at 31 March 2021

totalled only £55m, it seems unlikely that the Council could fund all of the next 3-4 years' capital programme in this manner. It should also bear in mind that reserves balances held to cover unexpected overspends and contingencies should be cash backed.

10. To resolve these apparent inconstancies, as a first step all the various sections of the Council's TMS need to be based on a consistent set of assumptions which are more explicit (and realistic) about:

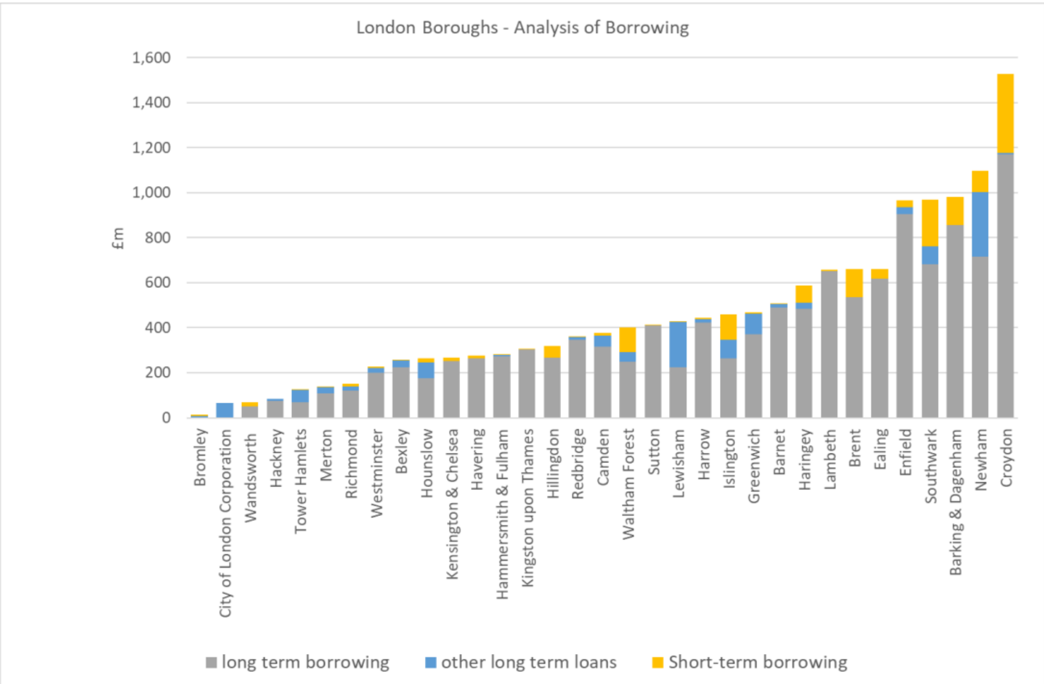
- whether new borrowing will represent external loans or utilisation of existing cash funds (unsupported borrowing), and
- the expected timing, duration, and borrowing costs, of any new external loan debt.

11. Realistically, if the Council continued with its previous capital programme it would need to incur additional external borrowing. Interest charges would then increase accordingly, and this would have an adverse impact on General Fund budgets.

12. Moreover, the current financing costs to revenue ratio has been calculated using an assumed interest rate of 0.25% rising to 1.25% by 31/3/2025 but:

- the OECD forecasts that UK interest rates will exceed 2% by January 2024;
- the Bank of England increased the base rate to 1.75% on 4/8/2022, and it seems highly likely that there will be further increases later this year.

13. Projected interest rate increases are especially relevant to Croydon because it has high levels of short-term borrowing, as shown below:



Source: published statements of accounts 2020/21

14. Using short term, variable rate borrowing has been an attractive option for many local authorities in recent years because while interest rates have been low and stable it has

generally been a cheaper and more flexible alterative to long-term borrowing at PWLB fixed term interest rates.

15. Low interest rates of under 1% since 2009 have limited the impact of increased borrowing on General Fund budgets, to the extent that some local authorities have regarded borrowing as a cost-free source of funding.

16. However, needing to regularly repay existing loans and renegotiate new ones is time-consuming for Council officers. Also, as borrowing rates are expected to rise in future so interest charges for this type of loan are likely to increase. A less risky strategy might be to match capital expenditure with long term, fixed rate loans with repayment profiles matched against the expected useful life of the asset.

Recommendations

R1. The Council's TMS needs to be more explicit, and more realistic about:

- **whether new borrowing will represent external loans or utilisation of existing liquid resources**
- **expected timings of any new external borrowing, and**
- **whether this borrowing will be long or short term**
- **the impact new loan debt will have on revenue debt charges and General Fund budgets in future years.**

R2. The Council should update its TMS, revenue budgets, and medium-term financial plans to reflect more up to date assumptions about future interest rates.

R3. Given the expected increase in UK interest rates going forward, the Council should also consider the potential benefits of:

- **a debt reduction strategy, and**
- **replacing short term, variable rate borrowing with long term, fixed rate loans where repayment profiles are matched against the expected useful life of the asset.**

5. Minimum Revenue Provision (MRP)

1. MRP is a legal requirement, specific to local authorities, which arises where General Fund capital expenditure has not been funded from either capital receipts, government grants, developer contributions or revenue financing. It requires an annual amount to be set aside from revenue budgets each year to reflect future repayments of this assumed new borrowing, irrespective of whether any actual new borrowing has taken place, or whether any loan repayments are in fact due.

2. Although the exact level of MRP charged each year is for the Council to decide, local authorities must "have regard to" statutory guidance issued by the Government. The current Statutory Guidance on MRP (2018 edition) sets out four options for calculating a prudent amount.

3. Para 23 of this Guidance does not preclude alternative calculation methods, but recent statements from DLUHC have re-emphasised that the Government expects this guidance to be followed and have clarified their expectation that MRP should be charged on all categories of capital expenditure including equity investments, commercial property and third-party loans.

4. Local authorities are required to publish their policy for calculating MRP which is then approved by elected members as part of the TMS. The published policy should:

   - explain the MRP framework and calculation options are as set out in current statutory and non-statutory guidance, and also

   - highlight any significant changes to the guidance since last year, and confirm that these requirements are being correctly applied.

5. Irrespective of the detailed method of calculation, in general terms MRP should:

   - be consistent with levels of external borrowing,

   - follow the trend of any changes in the Council's CFR, and

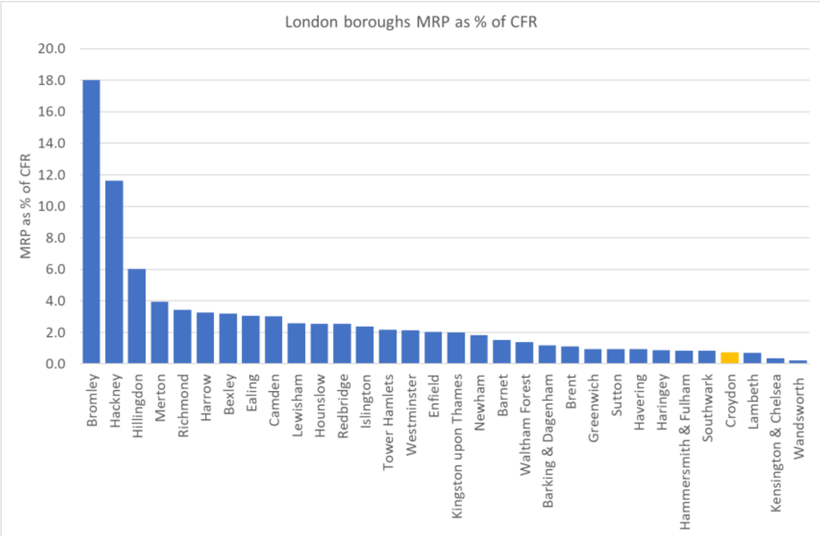
   - represent at least 2% of the closing CFR in any given financial year - this is external audit's current threshold for initiating more detailed review.

6. Our work confirmed that MRP calculations for 2018/19 through to 2022/23 are broadly in line with the published policy included set out in the TMS each financial year. However, in 2020/21, the Council's MRP charge of £12m was less than 1% of its CFR and 4th lowest of all London boroughs, as shown below. The Council has recently commenced a review of its MRP policy and underlying calculations, to confirm that:

   - the annual charge has been calculated in line with statutory and non-statutory guidance,

   - realistic levels of MRP have been built into General Fund budgets for future years, and that,

   - differences between the Council's level of MRP charges and those of neighbouring authorities can be justified and is clearly understood.



Source: published statements of accounts 2020/21

7. We have provided officers with examples of calculations prepared by other authorities which, in our view, comply with current Government expectations in full.

Recommendations

R1. The Council's published MPR policy should:

- **explain the MRP framework and calculation options are as set out in current statutory and non-statutory guidance,**
- **highlight any significant changes to the guidance since last year, and**
- **confirm that these requirements are being correctly applied.**

R2. The Council should review its MRP policy and underlying calculations, to confirm that the annual charge has been calculated in line with statutory and non-statutory guidance, and that realistic levels of MRP have been built into General Fund budgets.