Appendix 2

Borrowing Strategy 2023/24 to 2025/26

1. Background

1.1 Historically the Council has either been debt free or has had a very low-level of debt. This changed significantly in 2012 when, as part of the HRA reform, £265.9m of debt was transferred to the Council's HRA.

1.2 In January 2015, £89m was borrowed for the Council's General Fund (GF) from the European Investment Bank (EIB) to fund the regeneration of Abbey Road 2 and Gascoigne East (Weavers). Both schemes are now operational, bringing in sufficient income to cover the management and maintenance, lifecycle, capital, and interest costs, as well as generating income for the Council.

1.3 In November 2016, Cabinet approved the establishment of an Investment and Acquisition Strategy (IAS). The purpose of the IAS is to support the Borough's growth opportunities and to ensure that the Council, and future generations, benefit by increasing the Council's ownership of long-term income producing assets. The IAS is reviewed annually by Cabinet, with the next review to be taken to the March 2022 Cabinet. The IAS has an income target of delivering £6.6m per year from 2020/21. The IAS will be delivered primarily by the Council's development vehicle, Be First, and through its property companies, Reside.

1.4 The Council will ensure that all its investments are covered in the IAS and will set out, where relevant, it's risk appetite and specific policies and arrangements for non-treasury investments. It will be recognised that the risk appetite for these activities may differ from that for treasury management. The Council will set out a summary of existing material investments, subsidiaries, joint ventures and liabilities including financial guarantees and the Council's risk exposure.

1.5 <u>Key Borrowing Risks</u>

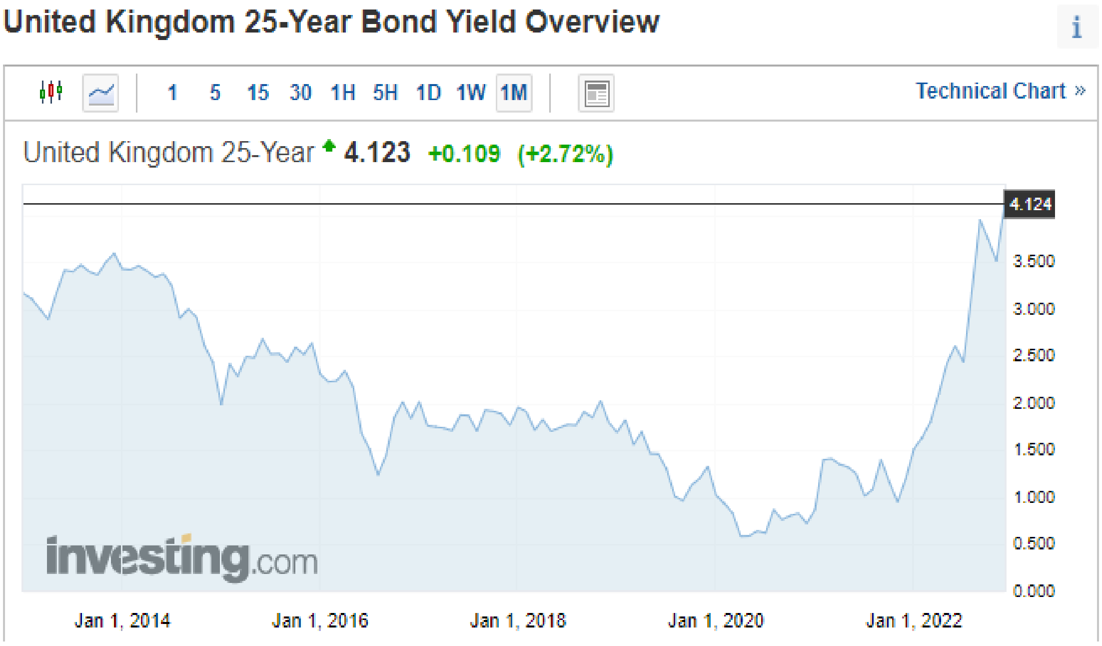
Over the past few years, with interest rates steadily decreasing, the cost of borrowing has decreased, with this decreased absorbing most of the IAS pressures caused by high build costs and low rent increases.

In 2022 this trend ended suddenly, with interest rates increasing significantly in a relatively short period of time, driven by inflation but also by a lack of confidence in the UK, which increased UK gilts, against which most of the Council's borrowing is linked to.

These pressures have generally been contained as the Council had already borrowed a lot of the IAS requirements but also the strategy had a fairly significant cash position and had a number of large property sales scheduled. In addition the Council borrowed £140m in 2021/22 at very low rates and any increases in borrowing costs during the construction phase are absorbed by relatively small increases to the build costs through the capitalisation of interest.

However there are a number of key risks, both unavoidable and avoidable risks and these are outlined below:

i) **High Interest Rates** – interest rates have increased during the year. Based on the 25 year gilts rate, rates have gone up from approximately 0.95% in November 2021 to 4.12% as at 30 December 2022. PWLB rates are based on Gilts plus 0.8%, meaning rates have increased from 1.75% to nearly 5% for borrowing over a 25-year period. This is highlighted in the table below:



This sudden change has had an impact on the agreed schemes, with the average borrowing costs likely to increase for the agreed schemes. It is important to note that the schemes that were agreed as at 31 December 2021 had required a reduced interest rate charge to ensure they remained viable. Currently there is a margin between the borrowing costs and on-lending and it is likely that this will be eroded, although there will likely still be a margin. For these schemes, as at 31 December 2022, £728m has already been spent, with a further £440m still required to complete the schemes. Approximately £75m will be funded from the sale of Welbeck and Pondfield, with the remaining £365m still to be borrowed.

ii) **Beam Park**

In 2022 a large scheme, Beam Park, was agreed by Cabinet. After issues with viability, Beam Park was agreed after rents increased sufficiently to make the schemes viable. The interest rate for Beam Park was increased to 3% to take into account the expected interest rate increases but the rate used was not as high as the current rates. There are some reasonable surpluses within the Beam Park returns and therefore an increased interest rate could be accommodated. Beam Park funding is also over a number of years, with interest capitalised during the development stage. On the basis that long term borrowing will only be taken when rates improve to below 4% funding Beam Park should still be possible, but the risk to the Council is much higher.

iii) **Gascoigne East Phase 3B (GE3b)**

GE3b was agreed by Cabinet in October 2022 despite the scheme not being viable. The main reason for the scheme not being viable was the high level of London

Affordable Rent being provided, especially provided using larger units, and a significant increase in build costs. In addition, part of the reason for the scheme not being viable was the increase in the on-lending rate, which was modelled at 4% but with scenarios of 5.5% (current rate) and 8%. The total amount of net borrowing required to fund GE3b is £138m.

A number of options to improve viability were put forward, including increased grant, reducing costs and reviewing rents, but there has been limited action on these and currently none of them are expected to be achieved. On this basis then scheme is forecast to lose an average of £2m per year for the first 20 years, before providing a small surplus for the next 30 years. To allow the scheme to be transferred to Reside to manage, it is forecast that some subsidy will be required, with a likely rate of between 2% and 2.5% charged.

Using a fairly simplistic calculation, should the Council need to use borrowing at 5.5% to fund GE3B, it will result in the average annual deficit for GE3b increasing over the first twenty years to between £6m and £7m, and increasing to £9 to £10.0m per year if borrowing was at 8%. This level of loss will need to be funded from surpluses within the IAS and will result in all profits from the IAS being lost and the potential for the IAS to provide a negative return to the Council, which will need to be funded by the IAS reserve.

Should borrowing costs reduce over the next three years to below 4%, should grant increase, the tenure changed to a more viable mix or operational costs improved then the deficit can be improved but this scheme has put a lot of pressure on the IAS and loss-making schemes should not be agreed in future as they are likely to start impacting other parts of the Council.

iv) **Pipeline and Pre-Gateway 4 schemes**

Several schemes that have not yet been agreed but some work has been completed on them. There are currently viability issues, but these are being addressed and there is the potential for these schemes to come to Cabinet in 2023. These schemes are provided below and will require many hundreds of millions of funding:

- Gascoigne East Phase 2 Block E1;
- Padnall Lake Phase 3,
- Brocklebank
- Barking Riverside Health Centre,
- Dagenham Heathway (Millard Terrace)
- Gascoigne East Phase 4 and Rest of Gascoigne West
- Heath Park Infill
- Hepworth Gardens-AR
- Ibbscott GW1
- John Burns Drive - AR & TR
- Padnall & Reynolds

While interest rates are high, to ensure agreed schemes are modelled prudently, a cost of borrowing level of between 4% to 5% will be required, which will make viability extremely difficult.

1.5 Capitalisation of Development Interest

1.5.1 The Council's IAS will increase the Council's interest payment costs. Were the Council to borrow a billion pounds at 2.15% (the current target average long-term debt rate) then the interest costs would be £21.5m per year, although this would decrease as debt is repaid. This will be funded by rental income from the various schemes but will result in a long-term obligation for future generations as some of the loans that will be taken out have maturity dates of up to 50 years.

1.5.2 During the construction stage there is a cost of carry as there is no income from the scheme. Interest incurred during the construction phase will be capitalised against developments that cost over £10m and that take in excess of two years to build. Capitalisation of interest starts from when the development has been agreed at Gateway 2. Where land has been purchased as part of land assembly the capitalisation of interest will be from the later date of the either the completion date of the purchase or the date of this accounting policy. Interest will be capitalised quarterly and is based on the weighted average borrowing costs. Cessation of capitalisation will occur when the scheme is operational.

1.5.3 As part of the Treasury outturn report, an outturn figure for the amount of interest that was capitalised for the year, will be provided to Members.

2. The Council's Borrowing Strategy

2.1 The decision to borrow is a treasury management decision and is taken by the Investment Fund Manager (IFM), after agreement by the S151 Officer under delegated powers of the Council's constitution. The key objective of the Council's borrowing strategy is to secure long term funding for capital projects and IAS at borrowing rates that are as low as possible.

2.2 Currently the Council has a hollistic approach to borrowing, taking into account cashflow, borrowing costs and investment and loan returns to drive the net cost of borrowing down, while keeping the borrowing transparent and simple.

2.3 The Council can borrow funds from the PWLB, capital markets, bond issuance and other local authorities. The Council borrows for several purposes, including:

(i) *Short term temporary* borrowing for day-to-day cash flow purposes.
(ii) *Medium term borrowing* to cover construction and development costs.
(iii) *Long-term borrowing* to finance the capital and IAS programme.

2.4 The IFM will monitor interest rates and will recommend borrowing decisions when rates are low, while taking into account the Council's debt repayment profile and cashflow requirements. The Council's borrowing strategy will give consideration to the following when deciding to take-up new loans:

- Use internal cash balances;
- Short-term borrowing from other Local Authorities;
- Using PWLB, the EIB or financial Institutions;
- Ensure new borrowings are drawn at suitable rates and periods;
- Consider the impact of grant and sales on long term borrowing; and
- Consider the issue of stocks and bonds if appropriate.

2.5 Based on current agreed schemes, 2023/24 to 2025/26 a significant amount of borrowing is still required, with the main borrowing required to fund the IAS. The borrowing requirments include schemes that have been agreed and are in various stages of devlopment and also pipeline schemes that have not been agreed but are included in the Be First Business Plan.

2.6 Currently interest rates are much higher than they have been over the past few years and this has resulted in a potential interest pressure should the high rates remain for a number of years. New borrowing is mainly short-term to keep average borrowing low, although even short-term rates are approaching 3.5%. The amount of borrowing towards the end of the financial year is higher than forecast due to delays in the sale of Welbeck and Pondfield. All new borrowing is to fund the IAS and therfore the increased borrowing costs is currently capitalised against the various projects. This has resulted in a fairly small increase in the scheme costs but will have a greater impact when schemes are completed and the captialsied interest ends and is replaced by a loan to Reside.

2.7 Officers are closely monitoring the cost of borrowing and have increased the financial models to include higher borrowing costs during the development period as well as on-lending rates. Unfortunately, along with higher build costs, lower than inflation rent increases and little movement on grant for social housing, this has resulted in most new schemes being unviable. Ongoing work is taking place to try and improve viability and prioritise schemes.

2.8 The Council recently agreed a scheme that is signficantly unviable, Gascoigne East 3b. Unless viability improves this scheme will have a significantly negative impact on the IAS but also the ability to contain borrowing costs. The impact of this couldd cause the whole IAS to become unviable and A summary of the borrowing required for IAS to for 2022/23 to 2025/26 is below:

IAS (net costs)	2022/23 £ms	2023/24 £ms	2024/25 £ms	2025/26 £ms	Total £ms
Residential	266.6	318.0	206.1	151.6	942.2
Commercial	51.7	0.5	0.0	0.0	52.3
Grants	-82.6	-79.1	-43.5	-45.1	-250.3
Capital Receipt	-3.4	-71.6	0.0	0.0	-75.0
Total IAS Borrowing	**232.4**	**167.7**	**162.6**	**106.4**	**669.2**

2.6 Excluding pipeline schemes, the borrowing required will take the Councils total borrowing to nearly £2bn by 2025/26, with pipeline schemes likely to take the borrowing to nearly £3bn over the next 7 years. Although the assets being purchased an built with this borrowing are in-borough and mainly residential, this exposure, especially considering the decline in investment returns and increase in cost of borrowing, needs to be reviewed from both a risk exposure but also capacity. Capacity issues have already been experienced with recent handovers. It is also important for Members to be aware that there are assumptions in the financial models, around costs, rent collection, maintenance etc that are challenging and need to be achieved for the schemes to provide a return and if these are not met then returns will be lower than forecast, with current forecasts already marginal.

3. Council's Current Debt

3.1 The Council currently (at 31/12/2021) has £1,181m of debt at an average rate of 2.47% and average duration of 25.48 years. The Council's General Fund (GF) debt is £885m at an average rate of 2.11% and an average duration of 22.61 years. This is broken down as follows:

	Principal £000s	Return %	Average Life (yr)	Principal £000s	Return %	Average Life (yr)
GF Fixed Rate Long Term Borrowing						
PWLB	635,780	1.92	29.27	617,887	1.91%	28.59
EIB	76,820	2.21	22.26	74,220	2.21%	21.26
DEXIA BANK LOBO	10,000	3.98	55.53	6,752	3.44%	23.76
L1 RENEWABLES	6,782	3.44	24.76	10,000	3.98%	54.53
Total GF Debt	**729,382**	**1.99**	**28.85**	**708,859**	**1.99%**	**28.14**
GF Short- and Medium-Term Fixed Rate Borrowing						
Local Authority ST	**55,000**	**0.03**	**0.13**	**146,228**	**2.99%**	**0.12**
GF MT Borrowing				**30,000**	**0.77%**	**1.64**
Total GF ST / MT	**55,000**	**0.03**	**0.13**	**176,228**	**2.61**	**0.38**
Total GF Debt	**784,382**	**1.85**	**26.83**	**885,087**	**2.11%**	**22.61**
HRA Fixed Rate Borrowing						
PWLB	265,912	3.5	35.1	265,912	3.50%	33.05
Market Loans	30,000	4.03	44.96	30,000	4.03%	42.99
Total HRA Debt	**295,912**	**3.55**	**35.06**	**295,912**	**3.55%**	**34.06**
Total Borrowing	1,080,294	2.32	29.09	**1,180,999**	**2.47%**	**25.48**

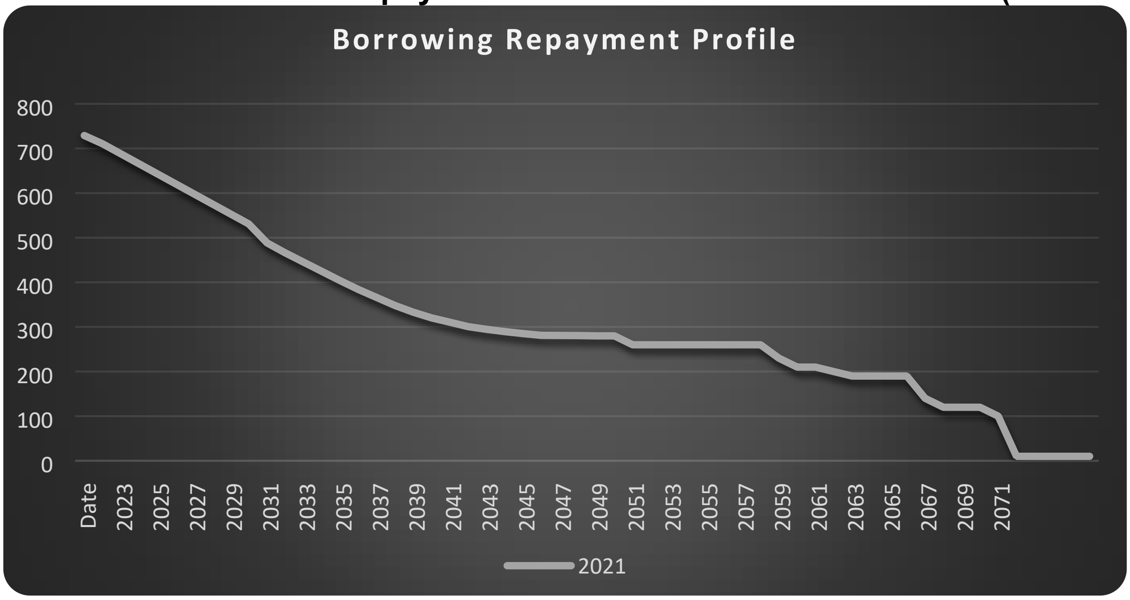
3.2 <u>General Fund Debt</u>

The GF debt can be split into short and long-term borrowing. Short-term borrowing is used to manage the Council's daily cash requirements and allows treasury to make strategic, longer term borrowing decisions while keeping the cost of carry low. Annual long-term borrowing amounts are summarised below. Repayments are from annuity and equal instalment repayments:

Year	Amount	Reason for Borrowing
Pre-2015	10	Capital Expenditure
2015	89	Abbey Road 2 & Gascoigne East Regen (Weavers)
2016	60	Film Studio Land
2017	120	Borrowing for Street Purchases and IAS
2018	150	IAS
2019	140	IAS
2020	60	IAS
2021	140	IAS
2022	176	IAS - mainly short and medium term
Various	-61	Borrowing Repaid
Total	**885**	

Although the borrowing is long-term, a part of the Council's debt is repaid each year through either an annuity repayment or equal instalment repayment. As a result, the Councils debt repayment profile is relatively smooth, as outlined in the chart below. Future borrowing will be mapped against this repayment profile and the forecast cashflows to help refinancing risk but also allow for a steady reduction in the Council's debt exposure. The chart below also shows the Council's borrowing repayment profile for long term borrowing as at 31 December 2022:

Chart 1: Council Debt Repayment Profile as at 31 December 2022 (millions)



3.3 General Fund Interest Costs

Currently the average long-term interest rate on GF borrowing is 1.99% for £708.9m borrowed. This rate drops steadily to 1.64% in 2070 but on a reduced balance, as borrowing is repaid. The average rate for the duration is 1.92%.

3.4 Borrowing from Financial Institutions

The treasury section will generally borrow from the PWLB when rates are low. However, where cheaper or more appropriate borrowing is available from other financial institutions then this is used as an additional source of financing. With the PWLB margin 0.8% above Gilts, this provides an excellent source of finance to support the Council regeneration strategy.

Currently the following loans have been borrowed from financial institutions:

i. European Investment Bank (EIB) Borrowing: In 2014/15 Cabinet agreed to borrow £89m from the European Investment Bank (EIB) as outlined below:

- £66m from the EIB to finance the Gascoigne Estate (East) Phase 1;
- £23m from the EIB to finance Abbey Road Phase 2.

The drawdown of the full £89m was completed on 30 January 2015 at a rate of 2.207% and currently the balance owed is £79.4m. The EIB loan does contain financial covenants that restrict to the Council's overall investment strategy. Discussions have been held with the EIB to increase the financial covenants of the EIB loan. These discussions have resulted in a significant increase in the covenant limits, as outlined below but also resulted in the interest rate from the EIB increasing by 1 basis point to 2.217% and a fee of £27,597.86 was payable:

i. the Total Debt shall not exceed 150% of Operating Revenues;
ii. Financing Costs shall not exceed 10% of Operating Revenues;
iii. Liquid Assets should be at least 1.2 times Short-term debt; and
iv. Debt Service shall not exceed 10% (ten percent) of Operating Revenue.

ii. Green Investment Bank (GIB) Borrowing (now L1 Renewables)

At its meeting on 2 December 2015 the Council agreed to borrow £7.5m from the GIB to finance the Low Energy Street Light Replacement Programme via the UK GIB Green Loan. On 15 December 2016, a loan of £7.0m was borrowed from the GIB at a rate of 3.44% for a duration of 30 years. The borrowing drawdown period will be over a two-and-a-half-year period and will match the forecast expenditure. The repayment of the loan has been structured to best match the cashflows expected to be generated from the energy savings.

3.5 HRA Self Financing

The Council uses a two loans pool approach for long-term debt. The £265.9m of PWLB is from the HRA reform in 2012, with an additional £30m of borrowing transferred to the HRA in 2016 and 2020 to finance HRA new builds. The HRA previously had a debt cap of £291.60 but this was removed in 2018. A breakdown of the HRA borrowing is provided in table 5 below:

Loan Type	Loan Amount	Maturity profile	Interest Rate
	£'000s	Yrs.	%
PWLB	50,000	24	3.51
PWLB	50,000	34	3.52
PWLB	50,000	42	3.49
PWLB	50,000	43	3.48
PWLB	65,912	44	3.48
Barclays	10,000	60	3.98
Phoenix Life	20,000	40	4.05
Total	**295,912**		

4. Repayment of Borrowing

As short term borrowing rates are usually cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, any savings will need to be based on the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy; and
- enhance the balance of the portfolio (amend the maturity profile).

Internal borrowing can also be reduced by generating capital receipts, which will replenish cash balances and in accounting terms be used for financing historic spend rather than for new capital projects.

5. Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved CFR estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.