

1. TREASURY MANAGEMENT IMPLICATIONS OF HRA REFORM

1.1. INTRODUCTION

- 1.1.1. The abolition of the housing subsidy system will either require housing authorities to take on additional borrowing to buy themselves out of the subsidy system or will give some authorities a lump sum. In addition local authorities will need to allocate existing and future borrowing costs between housing and the general fund as the current statutory method of apportioning debt charges between the general fund and HRA will cease.
- 1.1.2. This guidance is based upon CIPFA's understanding of the Department of Communities and Local Government 28th July 2011 policy document and the HRA and self financing draft determinations. It also incorporates comments received during the consultation process on the initial document entitled "Consultation on Proposed Capital Finance Arrangements under the New Housing Finance System". In its final form it will become part of the Treasury Management in the Public Services: Guidance Notes for Local Authorities including Police Authorities and Fire Authorities. This publication is being updated in the autumn 2011.
- 1.1.3. The consultation following the implementation of the Prudential Code identified concerns that the consolidated rate of interest (CRI) to allocate interest costs was a bar to authorities' ability to take advantage of the freedoms available to them under the Prudential Code. The use of the CRI also shares the benefits of using available internal resources, rather than borrowing, with the HRA based on debt proportions rather than resources available for investment. The abolition of the housing subsidy system and removal of the CRI provides a unique opportunity to remove this barrier and inequity.
- 1.1.4. This paper sets out a methodology for splitting loans to meet the requirements of the new system. The Government has signalled its intention not to impose a single solution and authorities may pursue other methods provided that they achieve principles approved by their full council.
- 1.1.5. Whilst this paper sets out the methodology for attributing loans to the HRA for accounting purposes, it should be remembered that the loans themselves remain a debt of the overall authority and the government will not be requiring the Public Works Loans Board to separate loans at source. All loans are charged indifferently on all the revenues of the authority in accordance with the Local Government Act 2003, and all loans have the

benefit of the 'safe harbour' provision which means that lenders do not need to enquire whether the authority has power to borrow the money and shall not be prejudiced by the absence of any such power.

- 1.1.6. The Section 151 officer retains overall responsibility for treasury management in an authority, which includes debt management.

Principles

- 1.1.7. The principles are as follows:

- The underlying principle for the splitting of loans, at transition, must be that of no detriment to the General Fund.
- Local authorities are required to deliver a solution that is broadly equitable between the Housing Revenue Account (HRA) and General Fund.
- Future charges to the HRA in relation to borrowing are not influenced by General Fund decisions, giving a greater degree of independence, certainty and control.
- Uninvested balance sheet resources which allow borrowing to be below the CFR are properly identified between General Fund and HRA.

Definitions relating to Housing Debt

- 1.1.8. There are a number of key definitions used throughout this paper.

Capital Financing Requirement (CFR)	The Capital Financing Requirement represents the authority's underlying indebtedness for capital purposes.
Subsidy Capital Financing Requirement (SCFR)	The amount of borrowing supported by the current subsidy system
Settlement Net Present Value (NPV) Debt	The amount of borrowing which can be sustained under the self-financing model.
Settlement Figure (SF)	The difference between the positive SCFR and Settlement NPV Debt which will be payable to/receivable from the Department for Local Government and Communities (DCLG) at settlement. Negative SCFRs are adjusted to zero for these purposes.
HRACFR (pre settlement)	The HRA share of the authority's total CFR – this may be lower than the SCFR due to the application of capital

	receipts or revenue resources.
GFCFR	The General Fund (residual) share of the CFR.
HRACFR (post settlement)	The housing CFR post settlement.
Unfunded CFR	The amount of CFR which is not funded by loans or other long term liabilities.
HRA Credit Arrangements CFR	The amount of HRA CFR which relates to credit arrangements.
HRA Loans CFR	The amount of HRA CFR which relates to loans.

Determining the quantum and components of HRA debt

- 1.1.9. The HRACFR represents the HRA's credit arrangements plus its underlying requirement to borrow to finance capital expenditure. It is the HRACFR which is used as the measure for DCLG to determine an authority's compliance with its limit on indebtedness or the maximum underlying debt requirement. If an authority borrows in advance of need this does not affect the level of indebtedness, which is determined by the level of HRACFR.
- 1.1.10. The HRACFR can be split between the 'HRA Credit arrangements CFR' and the 'HRA Loans CFR'. Gross HRA debt (including credit arrangements) is defined as the HRACFR plus any cash overdrawn, resulting from adverse cashflow movements and cash-related balances. A Cash in hand position, resulting from positive cashflows and balances, produces an HRA loans receivable balance.
- 1.1.11. In attributing a share of actual loans outstanding to the HRA, it is expected that generally only long term loans will be split. If the long term loans attributed to the HRA are less than the HRA loans CFR, this is referred to as an 'under-funded loans CFR', and the shortfall should be treated as HRA short term loans payable. If the HRA long term loans exceed the HRACFR, this is referred to as an 'over-funded loans CFR', and the excess should be treated as HRA loans receivable.
- 1.1.12. In addition to this, the HRA may have cash-related balances resulting from debtors, creditors and reserves, which should be treated as creating a cash overdrawn or cash in-hand position. This should also be treated as HRA short term loans payable or receivable. Authorities are likely to find it impracticable to separately attribute short term loans to the HRA, because of the high number and rapid turnover of such loans. It is likely therefore that they will continue to manage a single short term

loans portfolio, and apportion the costs on an appropriate basis. This is discussed further below.

1.1.13. The different components of HRA debt for treasury management purposes can accordingly be identified as follows:

- a. **Credit Arrangements** e.g. concession agreements and finance leases: the liability value outstanding on the balance sheet should always equal the HRA Credit Arrangements CFR.
- b. **Long Term Loans payable**: these should be separately identified loans taken by the authority and attributed to the HRA.
- c. **Short term loans payable or receivable representing an under-funded or over-funded CFR**: as discussed above, it is likely that these short term loans will not be separately identified to the HRA but will be managed in a combined HRA / General Fund portfolio.
- d. **Short term loans payable or receivable representing cash balances overdrawn or in hand**: the amount of cash balances will be estimated by the authority based on HRA balances and in-year cashflows, in a similar way to the 'revenue interest' calculation under the old Statutory Determinations. As with 3 above, these are unlikely to be separately attributed to the HRA.

The relationship of these four elements can be illustrated by a simple example:

Some alternative positions for an HRA with £10m Credit Arrangements CFR and £90m Loans CFR

Alternatives:	Fully-funded CFR A	Under-funded CFR B	Over-funded CFR C	Fully funded CFR (cash balances in hand) D	Fully funded CFR (cash balances overdrawn) E
HRA Credit Arrangements CFR: conc agr & Fin leases	10	10	10	10	10
HRA Loans CFR: long term loans	90	70	105	90	90
HRA Loans CFR: short term loans payable or receivable	0	20	-15	0	0
HRA Cash balances: short term loans pay. or rec.	0	0	0	-5	5
HRA Net Debt	100	100	100	95	105

The following figures can be produced from the above analysis:

HRA CFR	100	100	100	100	100
HRA Gross Loans Outstanding	90	90	105	90	95
HRA Gross Debt	100	100	115	100	105
HRA Loans Receivable	0	0	-15	-5	0

1.1.14. The different alternatives above are as follows:

- Alternative A shows an authority which has chosen to fully-fund its Loans CFR with long term loans.

- Alternative B shows an authority which has chosen to underfund its CFR i.e. it has not funded all its Loans CFR with long term loans but has left a balance of £20m represented by short term loans. It prefers to have some short term interest rate exposure.
- Alternative C shows an authority which has over-funded its Loans CFR, i.e. it has more long term loans than the Loans CFR, resulting in a surplus represented by short term loans receivable. This may be because it has actively decided to borrow in advance of requirement for the HRA.
- Alternatives D and E show variants of Alternative A for authorities which have cash balances in hand and overdrawn (respectively).

1.1.15. It is important that authorities assemble the whole picture of HRA debt above in order to make HRA treasury management decisions in the light of all the treasury exposures.

1.1.16. CIPFA's Treasury Management Code states that:

"Where external funds are managed on behalf of a third party or pension fund, these funds should be separately identifiable and income and expenditure attributed in line with an agreed policy."

It is accepted that HRA funds are not third party funds but funds of the authority and so will not necessarily be separately identifiable. That said, local authorities should have a clearly agreed policy approved by full council for attributing income and expenditure and risks between the general fund and HRA.

Accounting for HRA loans

1.1.17. The Capital Financing Requirement arises from capital expenditure to be financed from borrowing so reflects the cash values of borrowing. Loans should therefore be split according to the nominal loan value. The charge to the HRA for HRA borrowing, as set out in the statutory determinations, should be made in line with proper accounting practice, e.g. taking into account effective interest rates etc. as well as any statutory adjustments for the deferred write off of premiums and discounts etc. However, the separate calculation for unfunded HRACFR and cash overdrawn will need to be calculated by reference to nominal loans, rather than the loans outstanding figure on the balance sheet, which is influenced by accounting adjustments.

Understanding the Basis of the Settlement

1.1.18. This paper has been produced based on the following understanding of the settlement process:

- The settlement NPV Debt relates to the borrowing which the business plan can sustain after recognising the costs of other

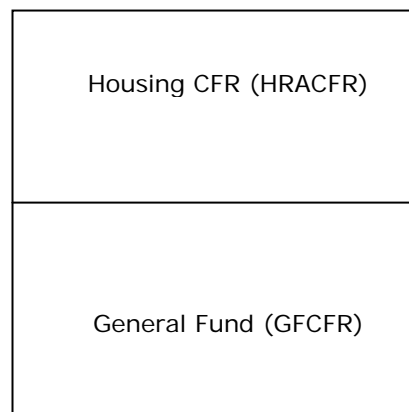
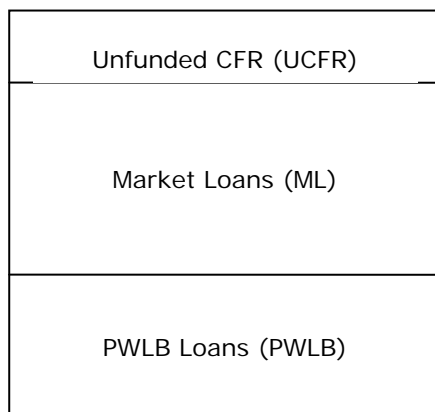
existing indebtedness such as leasing. Balance sheet premiums and discounts will be included in this calculation.

- The settlement figure is the transaction required between the DCLG and the local authority and is the difference between the settlement NPV debt and the SCFR. Where the SCFR is negative it is treated as nil for the purposes of the calculation.
- SCFR relates purely to borrowing and not the wider elements of debt, such as other long term liabilities.
- Where authorities are reducing debt, DCLG will make a payment to reduce the existing borrowing portfolio and cover any resultant premiums and discounts. PWLB loans will be repaid first.
- Where authorities are increasing debt to buy out of the subsidy system, the source of funding will not be prescribed by government.
- Any headroom between SCFR and HRACFR will be maintained as borrowing headroom under the debt cap.

1.2. PROPOSED SOLUTION: TWO LOANS POOLS (GENERAL FUND AND HRA)

Splitting Existing Loans

- 1.2.1. Currently the underlying debt requirement in local authorities may include credit arrangements, which will need to be deducted before the following analysis is undertaken. The residual CFR, referred to earlier as the loans CFR, may be funded through a mixture of Public Works Loan Board (PWLB) loans and market loans and an element may remain unfunded.
- 1.2.2. The diagram overleaf/below provides an example of an authority with all three elements satisfying the CFR for HRA and General Fund (again, this relates only to the borrowing requirement and not to any other long term liabilities or credit arrangements within the CFR):



- 1.2.3. Unfunded CFR is matched by authorities' use of the cash from reserves, revenue balances and favourable cash flow to reduce the need to borrow up to the level of the CFR.
- 1.2.4. In the main, this available cash relates to General Fund reserves and balances and consequently the HRACFR is, where possible, fully borrowed. The exception is interest on HRA balances which is covered by the calculation mentioned in paragraph 1.3.4. Where material HRA balances exist they should be taken into account in a local authority's calculations, either as an adjustment to the split of loans or by separate treatment as resources available for investment.
- 1.2.5. Where sufficient loans exist (market or PWLB), the loans taken on by the HRA are calculated as follows:

Housing share of PWLB $PWLB (H) = HRACFR / \text{total loans} \times PWLB \text{ loans}$

Housing share of Market Loans $ML (H) = HRACFR / \text{total loans} \times \text{Market Loans}$

Where insufficient loans exist ($HRACFR > \text{total loans}$), the balance is represented by unfunded CFR.

This is illustrated in the example below:

CFR Split	£	Existing Position	£
HRACFR	20,000,000	PWLB	28,000,000
GFCFR	24,000,000	ML	12,000,000
		UCFR	4,000,000
CFR	44,000,000	CFR	44,000,000
 HOUSING			
PWLB	$20,000,000 / 40,000,000 \times 28,000,000 = 14,000,000$		
ML	$20,000,000 / 40,000,000 \times 12,000,000 = 6,000,000$		
		HRACFR	20,000,000

- 1.2.6. Where the HRA takes on unfunded CFR, the choice is to take on additional borrowing to fully borrow up to the level of HRACFR or retain unfunded CFR and pay interest to General Fund in line with the policy on interest on balances. This choice will need to be exercised on the basis of the authority's overall cash flows, treasury and investment policies and strategies.
- 1.2.7. In order to ensure equity, all types of loans should be split between the HRA and General Fund. It is recognised that this will have practical implications but as the General Fund and HRA are likely to have different optimum maturity profiles and restructuring requirements in order to manage their treasury

management risks it is likely to be a preferable long term solution. Splitting loans may result in a minimal increase in administration but interest payments are already aggregated so there should be no additional transaction charges.

- 1.2.8. Where an authority decides to allocate a loan between the General Fund and HRA it may wish to ask the PWLB to physically split the loan rather than maintaining an internal apportionment. This will aid transparency and accountability. Where a loan has less than a year until maturity it is unlikely that there will be a benefit in physically splitting the loan. The PWLB will not be separating debt on settlement of the housing self financing transaction, but it would be open to authorities to approach the PWLB later.
- 1.2.9. Only Market loans taken as long term loans should be shared with the HRA. Generally, short term loans should remain GF loans, and any short term exposure of the HRA will be calculated via the interest on balances calculation (further discussed below). For market loans it will not be possible to physically split the loans but instead they can be split notionally and separated when they are next restructured. This does mean that decisions on initial restructuring of these loans will need to be taken balancing the corporate needs of the HRA and General Fund.
- 1.2.10. Where authorities can achieve a similar impact, including interest and maturity profiles, by allocation of complete individual loans between the two pools then this may be an easier route for them to adopt.
- 1.2.11. Once loans are separated post settlement, decisions may be required in terms of the rescheduling of loans for either the General Fund or HRA. An authority may be in the position that one pool wishes to repay loans and another take on new loans. If this is the case, an authority should consider whether it would represent overall value for money for the authority to transfer a loan at that point. For example, it may be that the cost of a higher rate of interest on an existing loan more than offsets the benefits of a reduced rate on a new loan when including the notional premium costs of repaying the existing loan.
- 1.2.12. Internal loans and investments between the HRA and the General Fund may also be appropriate, avoiding the credit risks of actual external investment. In such cases, authorities need to choose and evidence a fair rate of interest to charge.

Authorities with an increased debt requirement at Settlement

- 1.2.13. Where authorities make a payment to the Government at the settlement date this will be treated as capital expenditure which will automatically increase the HRACFR. The authority can then take out additional borrowing up to the level of the HRACFR. The cash for the payment to the government will come from the loan.

CFR Split	£'000	Existing Position	£'000
HRACFR	137,000	PWLB	135,000
GFCFR	21,000	ML	7,000
		Short term loans	2,000
		UCFR	14,000

CFR	<u>158,000</u>	CFR	<u>158,000</u>
------------	-----------------------	------------	-----------------------

HOUSING

PWLB	$137,000 / 142,000 \times 135,000 =$	130,246
ML	$137,000 / 142,000 \times 7,000 =$	6,754
	HRACFR	<u>137,000</u>

	£'000
Settlement Figure	32,000
Additional Borrowing (assume PWLB)	32,000
New Borrowing Figures	
	PWLB 162,246
	ML 6,754
HRACFR	<u>169,000</u>

Authorities with a reduced debt requirement at settlement

- 1.2.14. Where authorities receive a settlement from the Government this will be used to repay PWLB loans before any market loans. In order to ensure that loans can be repaid to the PWLB it will be necessary to repay the PWLB loans before splitting the residual loans between the HRA and General Fund. The repayment will reduce the HRACFR and hence reduce the amount to be apportioned to the HRA.
- 1.2.15. If an authority has borrowed in advance of need for a specific purpose, it would be appropriate for such loans to be excluded from the split.

CFR Split	£'000	Existing Position	£
HRACFR	711,000	PWLB	609,000
GFCFR	382,000	ML	484,000
		UCFR	0
CFR	<u>1,093,000</u>	CFR	<u>1,093,000</u>

Debt repayment

Settlement -553,000

CFR Split	£	Existing Position	£
HRACFR	158,000	PWLB	56,000
GFCFR	382,000	ML	484,000
		UCFR	0
CFR	<u>540,000</u>	CFR	<u>540,000</u>

HOUSING

PWLB 158,000 / 540,000 x 56,000 = 16,385

ML 158,000 / 540,000 x 484,000 = 141,615

HRACFR 158,000

1.3. SPECIFIC SITUATIONS

Debt Free Authorities

1.3.1. Several local authorities are known as being debt free. In strict terms they have a nil or negative debt requirement or CFR. In some instances, the General Fund CFR is positive and the HRACFR is negative, making the overall CFR negative or zero.

1.3.2. The examples below illustrate how the solution would work in debt free authorities:

CFR -13,000,000

Which includes	£
HRACFR	- 15,000,000
GFCFR	<u>2,000,000</u>

The negative CFR of £13M is supported by capital cash balances. £15m is HRA set aside capital receipts, of which £2m is used in lieu of borrowing for General Fund. Actual borrowing is zero.

Settlement

Settlement NPV Debt 100,000,000

SCFR -10,000,000

(negative SCFR is treated as zero for calculation of the settlement figure)

Settlement Figure (Payment to DCLG) 100,000,000

Funded by:

Cash balances	13,000,000
New GF borrowing	2,000,000
New HRA borrowing	85,000,000

100,000,000

Post Settlement CFRs

Payment to DCLG	100,000,000
HRACFR (pre settlement)	-15,000,000
HRACFR (post settlement)	85,000,000
GFCFR	2,000,000

CFR 87,000,000

- 1.3.3. It should be noted that the flexibility offered by the current rules enables no Minimum Revenue Provision (MRP) to be made on General Fund, as the overall CFR is negative. At settlement the CFR increases to become positive. The DCLG policy document published on the 28 July sets out proposals to amend the guidance on MRP so that the self financing settlement does not have any impact on the General Fund MRP.

Unfunded/Over-funded HRACFR

- 1.3.4. It is likely that due to differences in timing between expenditure and loans being drawn down that the identified HRA loans will not always match the HRACFR. In this case the unfunded or over-funded element will need to be taken into account in the interest on balances calculation. On the housing balance sheet the difference will show as either cash overdrawn or cash in hand with the analysis of the variation being reported as part of the treasury management reporting arrangements.
- 1.3.5. Where an authority undertakes borrowing that is short term in nature this should be managed centrally as part of overall cashflow management. The HRA element will be carried as unfunded/over-funded CFR and any charge to the HRA calculated as part of interest on balances. This allows the HRA to determine its own short term / long term borrowing mix by choosing whether to fully fund the HRACFR from long term loans.

Maturing HRA Loans

- 1.3.6. Once the loans are split they remain totally separate. Therefore, when an HRA loan matures it will need to be replaced by a new HRA loan dependent on the borrowing requirement at the time and the treasury management position. If no new loan is taken out this may create an unfunded HRACFR position resulting in cash overdrawn to be dealt with through the interest on balances calculation.

Borrowing in Advance of Need

- 1.3.7. Where an authority, as a result of an identified need and in line with their Treasury Management Strategy for the HRA, borrows in advance of need this will create an over-funded HRACFR position which will result in cash in hand to be dealt with through the interest on balances calculation. Any permissible facility for borrowing in advance of need must be clearly stated in the treasury management strategy at the beginning of the year in accordance with the prudential framework.

Loan Rescheduling after settlement date

- 1.3.8. Where PWLB has agreed to split loans into two to facilitate internal management, all rescheduling will be specific to HRA pool or General Fund pool. Where this has not happened, partial repayment of loans will enable independent management of the two pools.
- 1.3.9. For existing market loans the initial rescheduling will have to be carried out balancing the needs of the GF and HRA which are likely to be different. Future rescheduling will relate to loans that are already placed in one or the other pool.
- 1.3.10. As noted above, it may at times be mutually beneficial to move existing loans from the HRA to the General Fund portfolio or vice versa, recognising an appropriate 'internal' premium or discount. This avoids physically repaying and reborrowing, which would incur a significant loss on the repayment spread (particularly in the PWLB).

Transitional Issues

- 1.3.11. Settlement will take place on 28 March 2012, however, CFR and debt figures will not be finalised until the accounts are closed. The suggested approach deals with the difference in timing:
- Budgets and treasury management strategies can be compiled based on estimates.
 - New Borrowing from 1st April can be allocated to the new pools.
 - Existing loans should be frozen at the 1st April and apportioned as soon as final figures are known.

Where restructuring or replacement loans cannot be managed outside of this period, the replacement loan will need to be added to the pool of loans to be split once final figures are known. Accordingly, the actual request to PWLB to split loans would include all transactions from 1/04 to date.

1.4. **ALTERNATIVE SOLUTIONS**

- 1.5. Authorities may wish to use other principles to those stated in paragraph 1.1.7 which must be approved by full council as part of their Treasury Management Strategy. This may then lead them to alternative approaches as follows.

Three-Pool Approach

- 1.5.1. As an alternative to splitting existing loans, authorities may wish to pursue a three pool approach. Under this approach the existing loan pool will become one residual pool, which will reduce in value as loans are repaid at maturity or earlier. Borrowing for new capital expenditure, including the settlement payment, additional loans to cover under-borrowing and replacement loans would then be allocated to the two new separate pools, one for housing and one for General Fund.
- 1.5.2. Whilst initially this approach may seem attractive as it avoids the need to split existing loans, authorities will need to consider the method of allocating the costs of servicing the loans in the residual pool and impact of transactions moving forward.

One-Pool Approach

- 1.5.3. Local authorities may wish to continue with a single pool moving forward and to apportion costs according to locally established principles.
- 1.5.4. Whilst administratively this definitely has advantages the impact on the CRI of the settlement and the HRA business plan should not be under-estimated. Authorities will need to give careful consideration to the impact of the CRI on the business plan and the impact of any future volatility in the CRI. Maintaining a single pool approach may restrict the authority's ability to manage interest rates according to the HRA's loan and risk profile moving forward and ensure that treasury management supports the business plan.