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Northumberland
County Council

COMMITTEE: CABINET

9 OCTOBER 2018

REVISED GOVERNANCE FOR LOANS TO ARCH

Report of Barry Scarr, Executive Director of Finance and Deputy Chief Executive

Cabinet Member: Nicholas Oliver, Portfolio Holder for Corporate Services and Cabinet Secretary

1. Purpose of report

1.1 To seek agreement to a revised governance procedure for managing the loan facility relating to Arch and Advance Northumberland.

2. Recommendations

It is recommended that Cabinet:

1) Note the risk and governance issues surrounding the current process for granting loans to ARCH.

2) Agrees a revised decision making and governance procedure as set out in the report.

3. Link to Corporate Plan

3.1 This report is relevant to "We want to be efficient, open and work for everyone": Financial prudence – taking a proportionate approach to our use of reserves, our level of borrowing, the scale of our capital programme and our propensity for awarding grants and loans.

4. Key issues

4.1 The Council is projected to have awarded £275 million of loans to ARCH by 31 March 2019, and key risks need to be managed. The current governance arrangements are not robust enough, and the Council is not assessing the risk of the loans adequately. This report recommends changes to the decision making process in order to strengthen those arrangements..

5. Background

Current loans and process

5.1 The Council has granted loans to ARCH to carry out regeneration, commercial and development activities since the company's inception. The loan agreement with ARCH established a base rate of 5.75%, but various loan rates have been used historically:

5.75% - the normal rate
2.5% - during development phase of a capital investment
1.0% - for working capital
4.0% - affordable housing
4.5% - private rental housing
3.62% - the commercial portfolio transferred from Council
4.25% - Walkergate

5.2 These rates were personally agreed by senior officers within the Council, but were never formally approved or reported upon.

5.3 The current governance arrangements mean that the ARCH Board approve a scheme, and the interest rate (which has been used in the business case) is set by the Board at that point. ARCH then send a payment schedule to the Council, and the loan is transacted after signature by the Leader and Chief Executive. ARCH assess the state aid risk on projects related to the loan.

5.4 Treasury management best practice means that the Council should be assessing a series of risks associated with each loan:

Liquidity Risk: occurs when an individual investor, business or financial institution cannot meet short-term debt obligations. The investor or entity may be unable to convert an asset into cash without giving up capital and/or income due to a lack of buyers or an inefficient market.

Interest Rate Risk: is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve, or in any other interest rate relationship.

Market Risk: the possibility of an investor experiencing losses due to factors that affect the overall performance of the financial markets in which he or she is involved. Market risk, also called "systematic risk," cannot be eliminated through diversification, though it can be hedged against.

State Aid Risk: the risk that state resources are used to provide assistance that gives organisations an advantage over others.

5.5 The assessment of these risks has not occured in the past, and there are clear examples of where these risks have materialised:

- The large scale purchase of houses clustered in the same area has introduced liquidity risk - these assets cannot easily be converted into cash without destabilising the market and generating a loss.
- The financing of £278 million debt on a short term basis with the need to refinance over the next 5 years has introduced significant rate risk as interest rates rise. The fact that ARCH do not repay principal, with an expectation that the interest rate will cover the Council's interest and principal liabilities has also produced rate risk.
- The continuing downward trend in retail shopping asset valuation has materialised market risk.
- ARCH assesses the state aid risk on individual projects, yet it is the entity that grants the loan (not the receiver) that should be assessing the risk.

6. Proposed new process

6.1 In order to assess the risk on individual loans, the Council needs to analyse the factors in advance of ARCH receiving any loans. The process would start with the Council setting out an indicative range of interest rates for each purpose - e.g. social housing, affordable housing, market rent etc. These would then be used by ARCH to work up the business case for Board. If the business case is approved by the Board, then Arch would apply to the Council for a loan facility. The Council would examine the business case and any state aid advice, and then make an offer based on the risk analysis.

6.2 A number of core principles will apply:

- The Council is not willing to offer a loan facility over 100% of the asset value. Loans will no longer fund stamp duty, legal fees, estate agents or valuers fees and fixtures and fittings. A loan to value (LTV) covenant will avoid immediate day 1 liquidity risk.
- Where the business case is predicated on an income stream, the Council will insist on an interest cover covenant to cover market risk.
- Where rate risk is judged to be high, the Council may offer a floating rather than fixed rate to hedge any risk in the Council's funding profile. Alternatively, the rate may be pegged to baseline rate that reflects the Councils borrowing (long term PWLB) with a mark up to reflect risk.
- All proposals and requests for loans should include an estimate of loan duration.
- Not all loans will be interest only. There will be circumstances where principal repayment is part of the loan offer, especially if liquidity and market risk are deemed to be high and the proposed project is for a general commercial

purpose. Factors that will be considered when granting interest only loans will include:

- Assets held for a specific long term purpose (e.g. social housing).
- Loans for a specific regeneration project that requires public sector intervention.
- Assets held for a planned period before disposal.

6.3 An external loans Board to consider the risk around granting of loans will be set up consisting of:

- The Cabinet Member for resources (or nominated deputy)
- The Executive Director of Finance
- The Service Director - Finance
- The Treasury Management Accountant

6.4 The Board will not be considered quorate without the presence of an elected member.

6.5 Based on the analysis and recommendations of this Board, a loan offer will be made to ARCH by officers of the Council which the company can then accept or reject.

6.6 This process will only apply to new loans. The risk around existing loans will be dealt with as part of the transfer of liabilities from ARCH to Advance Northumberland.

6.7 The new process needs to be as streamlined as possible in order that unnecessary delay is not introduced into the system. The external loans Board will meet as soon as possible after the ARCH/Advance Board, and minimum timescales for decision making will be set out in the operating agreement between the Council and the Company. The way that the capital programme is developed will also be considered going forward , with a view to allocating specific amounts to activities carried out by Advance Northumberland rather than a global figure that contains the entirety of the annual borrowing requirement.

Implications

Policy	The reports is linked to the policy within the corporate plan in regards to financial prudence. Specifically, taking a proportionate approach to our use of reserves, our level of borrowing, the scale of our capital programme and our propensity for awarding grants and loans.
Finance and value for money	The report is financial in nature. All financial implications are contained in the body of the report.
Legal	
Procurement	Not applicable
Human Resources	Not applicable
Property	Not applicable
Equalities	There are no equality implications arising from this report.
Risk Assessment	The consideration of interest, market, liquidity and state aid risk is contained in the body of the report.
Crime & Disorder	Not applicable
Customer Consideration	Not applicable
Carbon reduction	Not applicable
Wards	All

Background papers:

Report sign off.

Authors must ensure that officers and members have agreed the content of the report:

	initials
Monitoring Officer/Legal	LH
Executive Director of Finance & S151 Officer	BS
Relevant Executive Director	BS
Chief Executive	DL
Portfolio Holder(s)	NO

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