The Chartered Institute of Public Finance & Accountancy

The Prudential Code for Capital Finance in Local Authorities

Consultation

February 2017

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed.

As the world's only professional accountancy body to specialise in public services, CIPFA's qualifications are the foundation for a career in public finance. We also champion high performance in public services, translating our experience and insight into clear advice and practical services. Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance.

The Prudential Code for Capital Finance in Local Authorities Consultation

Introduction

1. The *Prudential Code for Capital Finance in Local Authorities* (2011) (Prudential Code) was introduced in 2004 and local authorities are required to "have regard" to it when developing their capital investment plans. The Prudential Code was developed as a professional code of practice to support local strategic planning, asset management planning and proper option appraisal for local authorities when developing their programmes for capital investment in fixed assets. Its objectives are to ensure, within a clear framework, that capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. The prudential indicators within the Prudential Code are designed to demonstrate compliance with these objectives and to provide assurance to government that local authorities are acting responsibly.

2. The Prudential Code was last updated in 2011. Since then the landscape for local government has changed significantly following the sustained period of reduced public spending and the developing localism agenda. National Audit Office (NAO) work showed that revenue income for English local authorities fell by 25.2% in real terms from 2010/11 to 2015/16.[1] While capital spending operates within different rules, there are important interdependencies between the two. In 2016 the NAO[2] found that English local authorities have faced less pressure on their resources to support capital expenditure relative to revenue. It identified that the primary challenge has been to minimise the revenue cost of capital programmes. As a result, local authorities have needed to review their financial strategies, refocus their resources and explore different ways of working.

3. It is therefore considered an appropriate time for the Prudential Code to be reviewed and views sought as to areas where it can be strengthened or amended.

Objectives of the Prudential Code

4. The following objectives of the Prudential Code have not changed since its introduction and are to provide a framework for local authority capital finance that will ensure for individual local authorities that:

   i) capital expenditure plans are affordable

   ii) all external borrowing and other long-term liabilities are within prudent and sustainable levels

   iii) treasury management decisions are taken in accordance with good professional practice

   and that in taking decisions in relation to (i) to (iii) above the local authority is:

   iv) accountable, by providing a clear and transparent framework.

5. Given the changing environment within which the Prudential Code operates this consultation is seeking views on the ongoing relevance of these objectives.

---

[1] Comptroller and Auditor General, *Financial Sustainability of Local Authorities 2014*, Session 2014-15, HC 783, National Audit Office, November 2014.
[2] Comptroller and Auditor General, *Financial Sustainability of Local Authorities: Capital Expenditure and Resourcing 2016*, Session 2016-17, HC 234, National Audit Office, June 2016.

Consultation Question 1 Do you consider the four objectives of the Prudential Code are still relevant?

If not, please list the objectives which you feel are no longer relevant and why.

Consultation Question 2 Do you consider that the Prudential Code achieves these four objectives?

If not, please list the objectives which are not achieved and why.

Consultation Question 3 Do you consider that there are any areas which are not fully covered by these objectives?

If yes, please expand, describing how these areas could be covered within the objectives.

Scope

6. The Prudential Code applies to local authorities, including police, fire and other authorities. This consultation is seeking views on whether this coverage is considered adequate or whether its scope should be extended, especially where structures are changing such as with elected mayors and increasing numbers of arm's length organisations.

Mayoral combined authorities

7. In the Autumn Statement 2016, the government stated that it plans to give mayoral combined authorities powers to borrow for their new functions, which will allow them to invest in economically productive infrastructure, subject to agreeing a borrowing cap with HM Treasury. CIPFA is proposing to extend the scope of the Prudential Code to cover mayoral combined authorities and to require specific indicators such as the capital financing requirement to be produced for separate combined authority funds in a similar way to those produced for authorities with a housing revenue account.

Consultation Question 4 Do you agree that the scope of the Prudential Code should be extended to cover mayoral combined authorities?

If not, please provide your reasons.

Consultation Question 5 Do you foresee any practical implementation issues with extending the scope of the Prudential Code to cover mayoral combined authorities?

If yes, please detail the potential issues along with any suggestions you may have for overcoming them.

Group entities

8. The *Code of Practice on Local Authority Accounting in the United Kingdom* sets out a requirement for a local authority to prepare group accounts where the authority has interests in subsidiaries, associates and/or joint ventures, subject to consideration of materiality. A reporting authority is required to disclose information that enables users of its financial statements to evaluate:

   a) the nature of, and risks associated with, its interests in other entities, and

   b) the effects of those interests on its financial position, financial performance and cash flows.

Consultation Question 6 Do you agree that, in principle, the scope of the Prudential Code should be extended to cover group entities to ensure that any associated risks are transparent and managed?

If not, please explain why.

Consultation Question 7 Which areas of the Prudential Code could best be applied to group entities and do you foresee any practical implementation issues with extending the scope of the Prudential Code to cover group entities?

If yes, please detailed the potential issues, along with any suggestions you may have for overcoming them.

Commercialisation

9. With the ongoing reduction in available resources and growing demands for services, local authorities have found innovative new ways of delivering services, such as increasing use of local authority companies and different routes to generating income. Increasingly local authorities are focusing on commercials, including increasing the number of services which are commissioned, maximising the commercial value of contracts and developing local markets.
10. This new approach brings the need to consider new and different risks for local authorities. It is essential that such risks are managed in an open and transparent way and views are sought on how the Prudential Code can be strengthened to encompass these risks.

Consultation Question 8 How do you suggest the Prudential Code can be strengthened to encompass the risks associated with local authorities' increasing commercial activities?

Long term implications of decision making

11. Reports from Audit Scotland (March 2015) and the NAO (June 2016) both included recommendations in relation to considering the long term implications of decision making.
12. The framework established by the Prudential Code was intended to support local strategic planning, asset management planning and proper option appraisal. The prudential indictors are only required to be approved and published for three years when determining programmes of capital investment. Views are therefore sought from stakeholders as to how the strategic planning elements can be strengthened in the Prudential Code.

Consultation Question 9 How do you suggest the strategic planning elements of the Prudential Code can be strengthened to demonstrate that capital investment is sustainable and that risks are appropriately identified?

Prudential indicators

13. The prudential indicators in the Prudential Code are designed to demonstrate how a local authority is achieving the four objectives of the Prudential Code and to provide assurance to government that local authorities are acting responsibly. The indicators are grouped into affordability, prudence and those for capital expenditure, external debt and treasury management. The Appendix provides more details on the indicators along with their intended purpose.
14. Given the changing landscape for local authorities, views are sought on how the prudential indicators can be improved to enhance the assurance they provide.

Consultation Question 10 Please detail any suggestions for how the prudential indicators could be improved in order that the assurance they provide is enhanced, including details of any indicators which you consider no longer fully serve their intended purpose. Please explain your reasoning.

Consultation Question 11 If you use local indicators, please provide details including the calculation and how you use the indicator(s).

Treasury Risk Management Toolkit for Local Authorities

15. For many years CIPFA's Treasury and Capital Management Panel has advocated a risk management approach to treasury management and sought to provide practical tools for local authorities to use to identify, benchmark and manage their treasury management risks.

16. In 2012 the Panel produced the *Treasury Risk Management Toolkit for Local Authorities*. This publication proposed a risk management methodology based on:

    1. establishing the organisation's risk appetite
    2. quantifying risk benchmarks against which to measure the level of risk
    3. taking decisions and managing the portfolio based on the agreed risk benchmarks
    4. reviewing the outcomes and performance relative to the risk benchmarks.

17. The publication introduced the concept of the liability benchmark based on a local authority's net cash requirement, opening loan debt and any short term liquidity requirements. The Prudential Code focuses on the capital financing requirement (CFR) as a measure of borrowing need, however, the CFR does not take into account non-capital cash flows and movements and many authorities have a net loan debt below the CFR.

18. The Panel would like to formalise the concept of the liability benchmark in the Prudential Code and is seeking views and practical suggestions for implementation.

Consultation Question 12 How do you suggest that the Prudential Code can be strengthened to incorporate the concept of the liability benchmark?

Treasury Management in the Public Services: Guidance Notes for Local Authorities

19. As detailed in the Appendix, there are a number of treasury management indicators contained within the *Treasury Management in the Public Services: Guidance Notes for Local Authorities*. CIPFA is keen to receive feedback on whether the practitioners consider the balance of indicators between the Prudential Code and the *Treasury Management in the Public Services: Guidance Notes for Local Authorities* is correct.

Consultation Question 13 Do you consider that the balance of indicators between the Prudential Code and the *Treasury Management in the Public Services: Guidance Notes for Local Authorities* is correct?

If not, please explain why.

The consultation process

20. Responses to this consultation should be made in the accompanying Word document and returned to mandy.bretherton@cipfa.org by 21 April 2017.

21. The Treasury and Capital Management Panel will consider the consultation responses and then hold a further formal consultation on proposed changes to the Prudential Code over the summer. It is anticipated that the revised Prudential Code will be published in time for implementation in 2018/19.

22. The Treasury and Capital Management Panel is also seeking views on the Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. It is planned that the two consultations are run to the same timescales.

APPENDIX

Indicators for affordability

A. Ratio of financing costs to net revenue stream

This indicator, which provides an estimate for the forthcoming financial year and the following two financial years and the actual ratio after the year end, enables financing costs to be shown as a proportion of the net revenue stream.

This identifies the capacity of the local authority to respond to changes in financial costs. For example, an authority with a high proportion of financing costs when compared to its net revenue stream may be less able to respond to either increases in cost or reductions in net revenue stream.

B. Estimates of the incremental impact of capital investment decisions on the council tax

This indicator, which is undertaken for the forthcoming year and the following two financial years, enables the local authority to see the impact on council tax of proposed changes to the capital programme.

Indicators for prudence

C. Gross debt and the capital financing requirement

This indicator (which was changed from 'net' debt to 'gross' debt in 2012) is to ensure that over the medium term debt is only for capital purposes. A local authority's capital financing requirement is effectively its underlying requirement to borrow and is made up of capital expenditure which has not been financed from another source such as capital receipt, grant or directly from revenue.

By ensuring that debt does not (except in the short term) exceed the capital financing requirement (of the preceding year, plus estimates of any increases in the current year and next two financial years) a local authority is able to demonstrate that its debt is for capital purposes.

Indicators for capital expenditure, external debt and treasury management

D. Capital expenditure

The four indicators for capital expenditure are as follows:

- estimates of capital expenditure
- actual capital expenditure
- estimates of capital financing requirement
- actual capital financing requirement.

Estimates are for the forthcoming year and the following two years and actuals are for the previous financial year.

External debt

E. Authorised limit

Local authorities in England, Wales and Northern Ireland are required to determine and keep under review how much money they can afford to borrow. The authorised limit (set for the forthcoming and following two years) is the means of demonstrating the legislative requirements in England, Wales and Northern Ireland.

F. Operational boundary

The operational boundary is based on a local authority's most likely scenario for its external debt and is therefore a key tool for in-year monitoring.

G. Actual external debt

This is the closing balance at the end of the year, obtained directly from the balance sheet.

All three of these external debt indicators shall be expressed split between borrowing and other long term liabilities.

H. Treasury management

The indicator within the Prudential Code in respect of treasury management is that the local authority has adopted the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*. The aim is to ensure that treasury management is led by a clear and integrated treasury management strategy using a risk management approach and a recognition of the pre-existing structure of the authority's borrowing and investment portfolios.

The *Treasury Management in the Public Services: Guidance Notes for Local Authorities* (including police authorities and fire authorities) also include a number of specific treasury management indicators.

I. Interest rate exposures

A local authority is required to set upper limits on its fixed rate and variable rate exposures. This indicator facilitates the management of the risks associated with different fixed and variable interest rate exposures.

J. Maturity structure of borrowing

Upper and lower limits are set with respect to the maturity structure of borrowing (for the forthcoming and following two years). This indicator allows an authority to manage the refinancing risks associated with maturing borrowings.

K. Total principal sums invested for periods longer than 364 days

An upper limit shall be set for the maturity of investment for periods of longer than 364 days (for each forward financial year). This is to assist in managing the risks associated with the possibility of loss which may arise as a result of its having to seek early repayment of or redemption of principal sums invested.