The Chartered Institute of
Public Finance & Accountancy

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The Prudential Code for Capital Finance in Local Authorities

Consultation

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money. Further information about CIPFA can found on the CIPFA website.

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Executive Summary

CIPFA is pleased to publish this consultation on the review of *The Prudential Code for Capital Finance in Local Authorities (2017)* (Prudential Code). CIPFA wishes full opportunity for the sector to comment on the proposed changes and offer views to support the strengthening of the Prudential Code.

Since the Prudential Code's last review in 2017, over three years (2016/17 – 2018/19), £6.6bn was spent by councils on commercial property, with £2.3bn of that on retail acquisitions. This represents 14.4 times more spend on commercial property acquisitions when compared with the preceding three years. The further guidance made in the last update to the Prudential Code has not prevented a minority of councils taking disproportionate levels of commercial debt to generate yield, by misinterpreting the code or not having regard to its provisions, which are designed to protect public funds and local decision making.

As guardians of the Prudential Code, CIPFA will ensure the code is strengthened. Following the significant risk taken by a few local authorities with public funds to protect this system. The proposals outlined in this consultation, which clearly address that borrowing for yield only is unambiguously "in advance of need" are necessary. Without these strengthened provisions, local authorities risk further government intervention into the Prudential Framework.

CIPFA is committed to the Prudential Code regime to ensure local decision making is protected and that local authorities can deliver service innovation under a principles-based system. For the sector to continue to enjoy the freedoms of this system, the few outlying councils must end actions which either push the boundaries of the Prudential Code or intentionally misinterpret its provisions. The Prudential system has a key and clear role. As local authorities support the recovery of the impact of COVID-19, there is a need to invest in services, economic regeneration, infrastructure and housing. Should local authorities want to continue with these self-determinations for local investment, for now and for future generations, noncompliance with the code must cease.

Following the NAO Report and recommendation by the Public Accounts Committee in July 2020 that the Prudential Framework should be reviewed, CIPFA is dedicated to delivering on this commitment, to ensure that the Code and its objectives continue to support borrowing and capital investment in the modern era and ensure risks taken with public money are robustly managed and taken appropriately.

The areas we have proposed to strengthen are as follows:

- Further strengthen provisions within paragraph 45 of the Prudential Code to state clearly, that borrowing for debt-for-yield investment is not permissible under the Prudential Code. While recognising that commercial activity is part of regeneration, it does not constitute the primary purpose of investment and unnecessary risk to public funds.
- Any commercial investment undertaken should be consistent with statutory provisions, proportionate to service and revenue budgets and consistent with effective treasury management practice.

- Further strengthening the requirements to assess the affordability of commercial activity within local authorities' capital strategies. CIPFA will also publish, early this year, further guidance on good practice for development of capital strategies.
- The addition of sustainability and ensuring that the capital expenditure is consistent with a local authority's corporate objectives (such as diversity and innovation) to the objectives in the Prudential Code.
- Introduction of new prudential indicators on affordability. External debt to net service expenditure (NSE) ratio, and commercial income to net service expenditure.
- The introduction of the Liability Benchmark to promote good practice and understanding of local authority's debt management in relation to capital investment.

CIPFA welcomes your comments and responses on these proposals and thanks the sector for their time in responding. The consultation on Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes is also available for response and CIPFA recommends responding to both consultations.

Both consultations are open for response for 10 weeks. The closing date for responses is the 12 April 2021.

Introduction

The Prudential Code for Capital Finance in Local Authorities (2017) (Prudential Code) was introduced in 2004. Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, in Scotland under Part 7 of the Local Government in Scotland Act 2003 and in Northern Ireland under Part 1 of the Local Government Finance Act (Northern Ireland) 2011. 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.

Key objectives of the Code are to ensure, within a clear framework, that local authorities' capital investment plans are affordable, prudent and sustainable that treasury management decisions are taken in accordance with good professional practice and that local strategic planning, asset management planning and proper option appraisal are supported.

Since the Prudential Code was last updated in 2017 the landscape for local government investment has seen continuing growth commercial activity by a few outlying local authorities in the sector. The outcomes of the Public Accounts Committee (PAC) report also commented on the increasing trend in purchases of commercial property. One of the PAC recommendations was that the Prudential Framework be reviewed. In its submission to PAC, CIPFA reasserted its commitment to the Prudential Framework. However, CIPFA is committed to strengthening the Prudential Code to promote local decision making in line with its key objectives.

The growing trend in commercial investment was met with intervention from central government through the changes to PWLB lending terms, which CIPFA supports. CIPFA continues to be the guardian of codes of professional practice which enable regeneration and placemaking.

CIPFA intends to review both the Prudential and Treasury Management Codes to ensure that they remain fit for purpose. This consultation is the first of two consultations this year. This first consultation seeks views on a principles basis as to areas where the Prudential Code can be strengthened or amended and for proposals within the consultation to be commented on.

Consultation issues and questions

Borrowing in advance of need

In the last five years there has been an increasing trend for authorities to purchase property solely to make an investment return. Particular concerns arise when these investments have been financed from borrowing especially where this does not accord with paragraph 45 of the Prudential Framework, which states that **"Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed".**

CIPFA has issued extensive guidance on proper investments into property in its publication *Prudential Property Investment* (CIPFA, 2018) to assist local authorities in investment decisions in this area.

CIPFA is interested in views on the first sentence of paragraph 45 to ensure that local authorities clearly understand its meaning and implications.

CIPFA considers it might be helpful if more guidance to explain the provisions are included in the Prudential Code itself to assist local authorities in their decision making and to underline the importance of the Code's provisions in this area.

CIPFA would note that the provisions paragraph 45 including the new amendments apply equally to financial instruments and property investments.

EXTRACT OF PARAGRAPH 45 FROM THE PRUDENTIAL CODE WITH PROPOSED AMENDMENTS

SECTION SIX

Prudence and prudential indicators for prudence

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45 **Authorities must not borrow more than or in advance of their needs ~~purely~~ primarily in order to profit from the investment of the extra sums borrowed.** ~~Authorities should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds.~~ Therefore, local authorities **must** not borrow to fund primarily yield generating investments.

46 This prohibition does not cover borrowing where the primary aim is rooted in the function of the authority and the making of the return is incidental to the function eg regeneration. Authorities should also consider carefully whether they can demonstrate value for money in borrowing and can ensure the security of such funds. For examples how to assess this refer to the Prudential Property Investment Guidance (CIPFA, 2018).

Question 1: CIPFA is interested in stakeholders' views on the first sentence of paragraph 45? What alternatives would you suggest?

Question 2: Do you agree with the changes to paragraph 45 relating to the explanation of the sentence authorities must not borrow more than or in advance of need purely in order to profit from the extra sums borrowed? If not, why not? What alternatives would you suggest?

Objectives of the Code

As set out in the introduction there has been a substantial increase in commercial investment in recent years and it is vital that this investment is consistent with the principles in this Code and the prudential and statutory framework in which local authorities operate.

CIPFA is clear that its statement within the Prudential Code ie that authorities **must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed** (see earlier for more discussion on this issue) must be adhered to and has issued guidance in its publication *Prudential Property Investment.*

Paragraph 25 of the Code already sets out that commercial activity should be proportional to overall resources. However, CIPFA is of the view that to emphasise the importance of proportionality for capital expenditure generally and for commercial investment particularly that this should be explicitly included in the objectives of the Prudential Code. Note that these have been included on a principles' basis and subject to these principles being agreed more detail will be provided in the updated Prudential Code.

AMENDMENTS TO PARAGRAPH 1 OF THE CODE

SECTION TWO
Objectives

1 The framework established by the Prudential Code should support:
(a) local strategic planning
(b) local asset management planning
(c) proper option appraisal including ensuring that capital expenditure is sustainable in accordance with the corporate objectives of the authority.
The objectives of the Prudential Code are to provide a framework for local authority capital finance that will ensure for individual local authorities that:
(d) capital expenditure and investment plans are affordable and proportionate
(e) all external borrowing and other long-term liabilities are within prudent and sustainable levels
(f) any commercial investment undertaken should be consistent with statutory provisions, proportionate to service and revenue budgets and consistent with effective treasury management practice as outlined in (g)
(g) treasury management and other investment decisions are taken in accordance with professional good practice and that in taking decisions in relation to (d) to (f) above the local authority is:
(h) accountable, by providing a clear and transparent framework.
In exceptional circumstances the objective of the Prudential Code is to provide a framework that will demonstrate that there is a danger of not ensuring the above, so that the authority can take timely remedial action.

Question 3: Do you agree with CIPFA's proposal to add proportionality to the objectives within the Prudential Code especially with regard to commercial investments? If not, why not? What alternatives would you suggest?

Question 4: Do you agree with the introduction of an objective in relation to commercial investments? If not, why not? What alternatives would you suggest?

CIPFA would welcome any comments on the objectives in the Prudential Code to ensure that it remains fit for purpose and supports capital expenditure and investment in the 21st century. Sustainability is increasingly important to local authorities; for example, many authorities have declared a climate emergency and therefore it will be important that capital expenditure supports a local authority's climate objectives and that decisions are taken on a sustainable basis. Reference to sustainability has been added to the objectives of the Prudential Code. Again, this is on a principles basis more detail will be included in the updated Prudential Code.

Similarly, local authorities will want to ensure their capital projects are consistent with their corporate objectives such as diversity and innovation. This has therefore been explicitly included in the objectives of the Code. CIPFA would seek stakeholders' views on whether there are other issues which should be added to the objectives to ensure that they remain fit for purpose.

CIPFA would also be interested in views on the efficacy of the Code to ensure that it is able to understand how well the Code works in relation to its objectives but how well it supports local authorities in achieving those objectives.

Question 5: Do you agree with the proposal to add sustainability and ensuring that the capital expenditure is consistent with a local authority's corporate objectives (such as diversity and innovation) to the objectives in the Prudential Code? Please provide a reason for your response.

Question 6: Do you consider the current objectives of the Prudential Code to be relevant? Please provide a reason for your response.

Question 7: Do you consider that the provisions in the Prudential Code achieves these current objectives? If not, why not? Please provide reasons for your response.

Question 8: 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 and status of the Prudential Code

Section Three of the Prudential Code sets out the scope of how the Code applies to all local authorities, including police, fire, combined and other authorities which:

- in England and Wales are defined in legislation for the purposes of Part 1 of the Local Government Act 2003
- in Scotland are defined in legislation for the purposes of Part 7 of the Local Government in Scotland Act 2003, and
- in Northern Ireland are defined in legislation for the purposes of Part 1 of the Local Government Finance Act (Northern Ireland) 2011.

The executive summary in the Prudential Code covers its status. However, CIPFA is of the view that it would be beneficial to local authorities if the status was also included in the body of the Code itself to underline its importance and role in the statutory framework.

NEW PARAGRAPHS TO BE INTRODUCED TO THE PRUDENTIAL CODE

SECTION THREE

Scope and Status

…

12 The Prudential Code has been developed for local authorities as a CIPFA professional code of practice to support them in taking these decisions.

13 Local authorities are required by statutory provision and regulation to ‘have regard to’ the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, in Scotland under Part 7 of the Local Government in Scotland Act 2003 and in Northern Ireland under Part 1 of the Local Government Finance Act (Northern Ireland) 2011. Local authorities must therefore ‘have regard to’ the provisions in this Code. It is recognised that local authorities might have individual and local circumstances that need to be taken into account, which may for example require the addition of local indicators and where this is the case this should be clearly reported in the capital strategy.

Question 8: Do you agree with the proposals to include the status of the Prudential Code within the body of the Code itself. If not, why not? What alternatives would you suggest?

Capital strategy

The 2017 edition introduced the requirement to produce a capital strategy. The determination of a capital strategy should ensure that the authority is able to demonstrate that it takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability.

The guidance in Section Five of the Code includes a list of areas that authorities should have regard to in considering how stewardship, value for money, prudence, sustainability and affordability can be demonstrated. This list includes commercial activities.

Following the commentaries in the introduction related to the increase in commercial activities, CIPFA is of the view that it is important to augment this section with a particular focus on affordability and a need to demonstrate an understanding of what the risks are from commercial activities. For the avoidance of doubt this paragraph also includes a cross reference to the requirement in paragraph 45 of the Code, ie that an authority must not borrow in advance of need purely in order to profit from the sums borrowed. This is discussed in more detail at the beginning of the consultation.

AMENDMENTS TO PARAGRAPH 23 OF THE PRUDENTIAL CODE

SECTION FIVE

Process and governance Issues

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Commercial activity

- The authority's approach to commercial activities including processes ensuring effective due diligence and defining the authority's risk appetite in respect of these.
- An assessment of affordability and proportionality in respect of overall resources.
- Details of financial and other risks of undertaking commercial activities.
- Requirements for independent and expert advice and scrutiny arrangements.

While business cases may provide some of this material, these will often reflect historical rather than current circumstances so the information contained in them will need to be periodically re-evaluated when it will inform the authority's overall strategy.

[Note that Local authorities will also need to ensure that they comply with paragraph 45 and 46 of this Code.]

Question 9: Do you agree with the proposals to include additional commentary on the assessment of affordability and the details of risks of undertaking commercial activity within the commercial activities section on determining the capital strategy? If not, why not? What alternatives would you suggest?

Prudential indicators

The prudential indicators in the Prudential Code are designed to demonstrate how a local authority is achieving the objectives of the Prudential Code. Prudential indicators required by the Prudential Code are intended to support and record local decision-making in a manner that is publicly accountable on a local and a national basis. The Code suggests that the indicators are not designed to be comparative performance indicators (though obviously they provide internal comparisons for the authority itself). It is important though that the indicators should not solely record local decision making but should support the decisions made throughout local authorities' capital planning processes.

CIPFA would therefore seek stakeholders' views on the:

- number and usefulness of the indicators used in the prudential code
- where they might be reduced if they are not considered useful
- where new indicators might be needed to support decision making
- where more explanation or description might be needed in the prudential code to ensure that local authorities understand what they measure and why they are included.

Question 10: Please provide any suggestions that you might have for how the prudential indicators could be improved (as outlined above) in order that they might provide additional assurance for public accountability. Please explain your reasoning.

Prudential indicators on affordability

CIPFA has previously mentioned concerns on ensuring that capital expenditure plans should be proportional. Both CIPFA's *Guidance on Prudential Property Investment* (CIPFA, 2018) and the MHCLG's 2018 *Statutory Guidance on Local Government Investments* include provisions on ensuring that capital investment is proportional and therefore CIPFA proposes introducing two new prudential indicators for affordability:

- external debt to net revenue stream ratio, and
- income from commercial and service investments to net revenue stream.

New indicator: External debt to net revenue stream ratio

The external debt to net revenue stream ratio is intended to ensure that the amount of debt incurred is proportionate to a local authority's total service expenditure on a taxation basis and helps a local authority to understand the relationship of debt to an authority's resources used to support services and demonstrate a local authority's financial sustainability.

NEW PARAGRAPHS TO BE INTRODUCED TO THE PRUDENTIAL CODE

SECTION SEVEN

Affordability and prudential indicators for affordability

…

78 Estimates of external debt to revenue stream

79 As a minimum, the local authority will estimate for the forthcoming financial year and the following two financial years the ratio of external debt compared to budgeted net revenue stream. This prudential indicator shall be referred to as estimates of external debt to net revenue stream and shall be expressed as a ratio.

Estimates of external debt to net revenue stream = external debt ÷ net revenue stream expressed as a ratio for years 1, 2 and 3

80 Actual external debt to net revenue stream

81 After the year end, the external debt to net revenue stream ratio shall be calculated from the information in the local authority's outturn reports and balance sheet. This prudential indicator shall be referred to as actual external debt to net revenue stream and be expressed as a ratio.

Actual debt to net service expenditure = actual external debt ÷ actual net revenue stream expressed as a ratio

Question 11: Do you agree with the addition of the new indicator for external debt to net revenue stream to assess proportionality?

New indicator: Net income from commercial and service investments to net revenue stream

This ratio will consider an authority' exposure to risk from commercial and service investment income. It will allow members and the public to assess the authority's total risk exposure as a result of its investment decisions in commercial and service investments compared to the net resources it expends to support services on a taxation basis. Commercial income from fees and charges should be excluded. They should also be excluded from net service expenditure.

NEW PARAGRAPHS TO BE INTRODUCED TO THE PRUDENTIAL CODE

SECTION SEVEN

Affordability and prudential indicators for affordability

…

82 Estimates of net income from commercial and service investments to net revenue stream

83 As a minimum, the local authority will estimate for the forthcoming financial year and the following two financial years the ratio of net income from commercial and service investments compared to budgeted net revenue stream. This prudential indicator shall be referred to as net income from commercial and service investments to net revenue stream and shall be expressed as a ratio.

Estimates of net income from commercial and service investments to net revenue stream = net income from commercial and service investments ÷ net revenue stream expressed as a ratio for years 1, 2 and 3

84 Actual net income from commercial and service investments to net revenue stream

85 After the year end, the net income from commercial and service investments to net revenue stream ratio shall be calculated from the information in the local authority's outturn. This prudential indicator shall be referred to as actual net income from commercial and service investments to net revenue stream and be expressed as a ratio.

Actual net income from commercial and service investments to net revenue stream = actual net income from commercial and service investments ÷ actual net revenue stream expressed as a ratio

Question 12: Do you agree with the addition of the new indicators for net income from commercial and service investments to net revenue stream to assess proportionality?

New indicator: Liability benchmark

Affordability is one of the key objectives of the Prudential Code. It is vital that an authority understands the resources it needs and its commitments in terms of borrowing and investment and the impact on services and treasury decisions.

CIPFA is therefore proposing to introduce the liability benchmark as a new indicator to measure borrowing levels and the profile of its debt overtime. This indicator is based on its future cash flows and their forecast minimum revenue payment (MRP) for repayment of debt in the future. If debt exceeds the liability benchmark the authority has a cash surplus and is holding on deposit. It is a measure of an authority's existing (and committed) loans portfolio that is compared with its forecast loan needs. This benchmark should enable the authority to understand and manage its exposure to treasury risks. Using the benchmark maturity profile or net loans benchmark enables the authority to minimise its treasury risks by matching its maturity profile to the liability benchmark.

This new indicator has been introduced because it will assist local authorities with affordability decisions but there are arguments that this indicator might be better placed in the Treasury Management Code as it also assists with treasury management decisions. CIPFA would be interested in stakeholders' views on this issue.

NEW PARAGRAPHS TO BE INTRODUCED TO THE PRUDENTIAL CODE

SECTION SEVEN

Affordability and prudential indicators for affordability

90 The liability benchmark

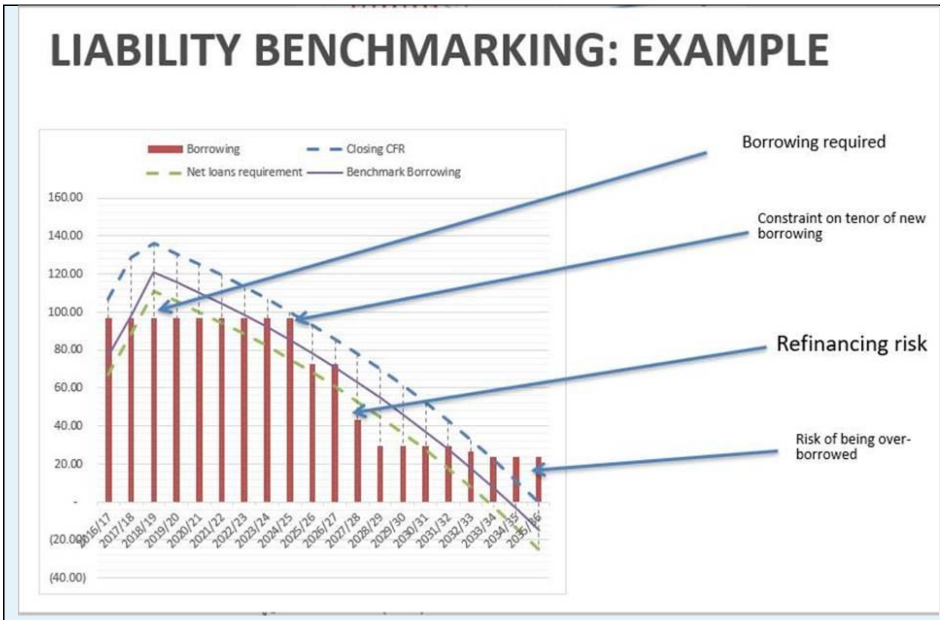
91 As a minimum, the local authority will estimate and measure the liability benchmark for the forthcoming financial year and the following two financial years. However, CIPFA recommends that liability benchmark is produced for at least 10 years and should ideally cover the debt profile of a local authority. The liability benchmark is not a single measure but requires graphical presentation of the net loans requirement and compares this with the Capital Financing Requirement and actual debt.

Liability benchmark = Net loans requirement + short term liquidity allowance compared with capital financing requirement and actual debt

Net loans requirement is Net Loan Debt balance projected into the future based on its forecast cash flows (ie its Net Cash Requirement)

Short-term liquidity allowance means an allowance for a level of excess cash to be invested short term to provide access to liquidity if needed (due to short-term cash flow variations, for example).

92 The liability benchmark should be presented as a graph an example of which is provided below:



[Note that the Prudential Code will cross refer for extra guidance (by means of a footnote) to the *Treasury Risk Management Toolkit for Local Authorities* CIPFA, 2012)]

Question 13: Do you agree with the introduction of the liability benchmark as an affordability indicator?

Question 14: Do you consider that the liability benchmark should be included in the Prudential or Treasury Management Code?

Gross debt and the capital financing requirement

The gross debt and the capital financing requirement indicator is a prudential indicator for prudence which is intended to ensure that medium term debt is only for capital purposes. CIPFA is of the view that the introduction of the liability benchmark which offers information to the authority on both affordability and allows investment decisions to be made prudently then there is no need for an explicit indicator which compares these two items. CIPFA therefore proposes removing this indicator from the Prudential Code (this would require the deletion of paragraph 62 from the Prudential Code).

Question 15: Do you agree with the removal of the prudential indicator gross debt and the capital financing requirement CFR on the basis that it is included as part of the liability benchmark which is to be introduced as a prudential indicator?