LGA Resources Board
2 March 2021

CIPFA Consultations on the Prudential Code for Capital Finance in Local Authorities and on Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes

Purpose of report

For direction.

Summary

This report outlines the consultations being undertaken by CIPFA on reviews of the Prudential code and the Treasury Management code. This, the first stage of a two-stage consultation process, focusses more on principles rather than detailed wording. This report seeks a steer from members on what points to include in a response to CIPFA, in particular in relation to the changes proposed with regard to commercial investment by local authorities.

Recommendations

Members are asked to consider the two consultations from CIPFA and the give a steer to officers on points to include in a response. The full response will be submitted to Resources Board Lead Members for clearance.

Action

Officers to draft the LGA response in line with the steer from Resources Board.

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Background

1. The Prudential Code for Capital Finance in Local Authorities (the "Prudential Code") was introduced in 2004 and last revised in 2017 for application from April 2018. The code came about through the 2003 Local Government Act which enabled councils to set their own capital financing plans. Under section 3 of the 2003 Act each local authority was given a duty to "determine and keep under review how much money it can afford to borrow." In order to do this regulations (the capital finance regulations 2003) were laid by the Secretary of State that in order to discharge that duty local authorities "shall have regard to the code of practice entitled the "Prudential Code for Capital Finance in Local Authorities" published by CIPFA, as amended or reissued from time to time". Similar regulations were laid by the Welsh Government to govern Welsh local authorities.

2. These changes were a major step in freeing local government from centrally imposed borrowing controls and the Government placing genuine trust and reliance in local government's ability to manage its own affairs according to the sector's own professional standards. The track record of local government since the Prudential Code was first introduced has shown both that local government has proved worthy of that trust and the code has an important place in enabling successful locally determined capital investment by local authorities.

3. The Treasury Management Code of Practice ("Treasury Management Code") was introduced in 2001/02. Again, local authorities are required to "have regard" to the code in setting up and approving their treasury management arrangements. In practice the code is widely used, and it is likely that any local authority not following it would be required to justify (eg to its external auditors) why it had not used it.

4. The Prudential Code, and the Treasury Management Code form two parts of what is known as the Prudential Framework. In England, the other two parts are statutory guidance published by MHCLG - Guidance on Local Authority Investments ("Investments Guidance") and the Guidance on Minimum Revenue Provision ("the MRP Guidance"). These were also last revised with effect from 1 April 2018.

5. The current consultations by CIPFA on the Prudential Code and the Treasury Management Code are the first stage of a two-stage process. The current consultations cover "principles" and close on 12 April 2021. The plan is for a second consultation on proposed new wording of the codes to be undertaken between May and August, with revised codes expected to be published and operational from October 2021.

6. The current review is being undertaken in response to the report last year of the Public Accounts Committee into local authority investment in commercial property. The 2003

Act gives local authorities the power to invest: Section 12 of this Act ("Power to invest") states that "A local authority may invest – (a) for any purpose relevant to its functions under any enactment, or (b) for the purposes of the prudent management of its financial affairs". However, the report raised questions about funding these investments through borrowing and some of the proposed changes seek to tighten the codes' rules over such investments. In its introduction to the consultation CIPFA states that "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." As noted above, the revised code came into effect with effect from April 2018 at the start of the financial year 2018/19.

7. The rest of this paper highlights key questions in each consultation and seeks members views on a possible response. The full list of questions for each consultation is appended to the paper.

Prudential Code consultation and comments

8. The Prudential Code consultation asks 16 questions.

9. Questions 1 and 2 are detailed questions about statements on policy on commercial investments and are about specific wording in a paragraph in the code (paragraph 45) and a suggested additional paragraph (new paragraph 46). Question 1 asks for views on the wording on the current paragraph 45 and question 2 asks for views on changes to the wording and on a new paragraph 46.

10. Paragraph 45 currently reads: "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. 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."

11. The proposed new wording of para 45 and the new paragraph 46 is as follows:

    - 45. Authorities must not borrow more than or in advance of their needs primarily in order to profit from the investment of the extra sums borrowed. 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).

12. The existing words in paragraph 45 have been in the code since at least 2011 (and possibly in the original code) and were not altered in the review undertaken in 2017. The

paragraph refers firstly to borrowing purely to generate a return ("more than need") and secondly to the timing ("advance of need") of loans taken out to fund capital expenditure and while it acknowledges that the timing of taking out a loan can be influenced by value for money considerations (for example better treasury management) it does not allow for borrowing early purely to invest the sums to make a return.

13. The words in paragraph 45 are also included in the Statutory Investment guidance which is issued by MHCLG for England. Changes were made to this in 2017 to apply from 1 April 2018 to say that "The definition of an investment covers all of the financial assets of a local authority as well as other non-financial assets that the organisation holds primarily or partially to generate a profit; for example, investment property portfolios." Prior to this the guidance referred to financial assets only. The stated intention of this particular change to the statutory investment guidance was to make it clear that borrowing to fund acquisition of non-financial assets solely to generate a profit is not prudential.

14. The intention of the changes proposed in the current review of the Prudential Code are to prevent local authorities from borrowing in order to invest in yield generating investments such as commercial property. Members may wish to take the view that:

    14.1. The proper place for such a policy is the statutory investment guidance from MHCLG (or the Welsh Government for Wales), rather than the Prudential Code. The proper purpose of the Prudential Code is to enable local authorities to assess the affordability of borrowing not to decide what that borrowing is for.
    14.2. That the proposed changes are in any case redundant and likely to cause confusion as the issue is already addressed in the statutory investment guidance using the current wording (see above).
    14.3. That the proposed changes are likely to have further unforeseen consequences as the wording is not clear, especially in the new proposed paragraph 46. For example, this paragraph refers to borrowing being allowed where "the primary aim is rooted in the function of the authority".

15. Questions 3, 4, 5, 6, 7 and 8 of the consultation cover proposed changes to the objectives of the code, largely introducing additional objectives relating to proportionality of commercial investments and to sustainability (as well as asking general questions on objectives). Such changes are unlikely to be objected to by individual councils. Question 9 proposes that the status of the code be referred to in the body of the code itself. CIPFA.

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16. Question 10 covers "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". The intention is to

make risks better understood and so aid decision making. Members may take the view that this is appropriate.

17. Questions 11 to 16 cover proposed revisions to technical indicators used to calculate how much a local authority can afford to borrow. The views of individual local authorities and of finance practitioners within the sector on these proposed changes will be important.

Treasury Management Code consultation and comments

18. The Treasury Management Code consultation includes 7 questions. These are mostly aimed at strengthening the skills and knowledge within local authorities to manage treasury management activities. Treasury management is a highly specialist area that can have a big financial impact. As such it is hard to argue anything other than it needs to be managed with a high level of knowledge and skill with an appropriate and informed attitude to risk.

19. However, question 6 recommends that local authorities set up a dedicated committee to manage treasury management ("Do you agree more complex treasury management functions (ie a professional client under MiFID II legislation) means that local authorities would benefit from the support of a dedicated committee to review decisions and strategies and that CIPFA should recommend this in its guidance provided to local authorities?"). It is not clear what the role of such a committee would be – full council has to approve the Treasury Management strategy and officers have to then work within its parameters. Members may take the view that such governance issues are for individual local authorities to decide, or that the area needs to be overseen by members with specialist skills, or a specialist committee may take accountability one step further away from full council. It could be proposed that some attention should be paid to making sure the subject can be presented to members in plain language, for the intelligent non-expert. If so, CIPFA should have a role to play in helping finance practitioners to de-mystify the subject.

Next steps

20. Members are asked to consider the two consultations from CIPFA and the give a steer to officers on points to include in a response.

21. Officers will draft the LGA response in line with the steer from Resources Board. And submit it to Resources Board Lead Members for clearance.

Implications for Wales

22. The codes apply to both Welsh and English local authorities. Oversight of the regime and issuance of related statutory guidance, such as guidance in investments, is the

responsibility of the Welsh Government in Wales and MHCLG in England. Officers are discussing the implications of the proposals with the Welsh Local Government Association.

Financial Implications

23. This is part of the LGA's core programme of work and as such has been budgeted for in 2020/21 core work programme budgets.

Appendix 1 – Prudential Code consultation questions

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?

Paragraph 45 / 46 with proposed deletions struck through and additions in italics are

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 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?

(The proposed objective added in the consultation is
any commercial investment undertaken should be consistent with statutory provisions, proportionate to service and revenue budgets and consistent with effective treasury management practice)

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.

Question 9: 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?

Question 10: 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?

Question 11 (including preamble)
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 11: 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.

Question 12: Do you agree with the addition of the new indicator for external debt to net revenue stream to assess proportionality?

Question 13: 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?

Question 14: Do you agree with the introduction of the liability benchmark as an affordability indicator?

Question 15: Do you consider that the liability benchmark should be included in the Prudential or Treasury Management Code?

Question 16: 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?

Appendix 2 – Treasury Management Code consultation questions

Question 1: Do you agree with the proposal that organisations that have adopted the Treasury Management Code will have to explicitly document a formal and comprehensive knowledge and skills schedule to ensure the effective acquisition and retention of treasury management skills for those responsible for the management, delivery, governance, decision-making and compliance with legislative requirements? If not, why not? What alternatives would you suggest?

Question 2: Do you agree with the proposals for what should be included in a knowledge and skills schedule?

Question 3: Do you agree with the proposals for the monitoring and review of treasury management knowledge and skills? Do you agree that these are best specified in guidance to the Treasury Management Code? If not why, not? What alternatives do you suggest?

Question 4: Do you agree that guidance to the Treasury Management Code should include specifications on key competencies for treasury management roles?

Question 5: Do you agree with the addition of a new TMP to address environmental, social and governance risks? If not, why not? What alternatives do you suggest?

Question 6: Do you agree more complex treasury management functions (ie a professional client under MiFID II legislation) means that local authorities would benefit from the support of a dedicated committee to review decisions and strategies and that CIPFA should recommend this in its guidance provided to local authorities? If not, why not? What alternatives would you suggest?

Question 7: Do you agree with the removal of the maturity structure of borrowing treasury management indicators on the introduction of the liability benchmark indicator? If not, why not? What alternatives would you suggest?