CAB320
FOR DECISION
WARD(S): GENERAL

CABINET

21st May, 2003

CIPFA PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES

REPORT OF THE DIRECTOR OF FINANCE

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RECENT REFERENCES:

CAB441: Draft Local Government Bill, 24th July, 2002

EXECUTIVE SUMMARY:

The Chartered Institute of Public Finance and Accountancy (CIPFA) has issued a second consultation paper on a Prudential Code for Capital Finance in Local Authorities. Local authorities will be required to comply with the Code.

The new system will be one based largely on self regulation by local authorities with the basic principle that local authorities will be free to invest so long as their capital spending plans are affordable, prudent and sustainable. The Code will set out the indicators that local authorities must use, and the factors that they must take into account, to demonstrate that they have fulfilled this objective. The Code will take effect from April 2004 and thus its requirements will have to be taken into account in the process for setting the 2004/05 budgets, that is, during 2003.

The objective of the Code is to provide a framework that will ensure for individual local authorities that: capital expenditure plans are **affordable**, all external borrowing and other long term liabilities are within **prudent and sustainable levels**, and treasury management decisions are taken in accordance with **professional good practice.** In taking such decisions the local authority is required to be **accountable**, by providing a clear and transparent framework. Further, the framework established by the Code should be consistent with and support local strategic planning, local asset management planning and proper option appraisal.

Appendix A sets out the 18 indicators that authorities will be required to set and monitor. A further report on these will be brought back later in the year so that Members can determine the levels at which the indicators should be set.

RECOMMENDATIONS:

1. That the principles of the code are supported and regard be had to them through the budget process this year.

2. That comments as outlined in Appendix B be submitted to CIPFA.

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DETAIL:

1 Introduction

1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) has issued a second consultation paper on a Prudential Code for Capital Finance in Local Authorities following comments on its first paper issued in December, 2001. Comments were sought by 15th May, 2003.

1.2 The Government issued a Green Paper in September, 2000 on modernising local government finance and this code has been developed in response. It is referred to in the Government publication Strong Local Leadership – Quality Public Services as the regime that will replace the existing system of credit approvals. Local authorities will be required to comply with the Code.

1.3 The Code will replace the present complex regulatory frameworks governing local authority capital expenditure. The new system will be one based largely on self regulation by local authorities themselves. The basic principle of the new system is that local authorities will be free to invest so long as their capital spending plans are affordable, prudent and sustainable. The Code will set out the indicators that local authorities must use, and the factors that they must take into account, to demonstrate that they have fulfilled this objective. The Code will not include suggested or indicative limits or ratios. These will be for the local authority to set itself. The Code will take effect from April 2004 and thus its requirements will have to be taken into account in the process for setting the 2004/05 budgets, that is, during 2003.

1.4 A copy of the draft Code is available in the Members' Room and also on www.cipfa.org.uk. Extracts of the text are included in this report together with an officer commentary. A response to the consultation is shown in Appendix B.

2 Objective

2.1 The objective of the Code is to provide a framework that will ensure for individual local authorities that:

(a) Capital expenditure plans are **affordable**

(b) All external borrowing and other long term liabilities are within **prudent and sustainable levels**

(c) Treasury management decisions are taken in accordance with **professional good practice**

and that taking decisions in relation to (a) to (c) above the local authority is

(d) **Accountable**, by providing a clear and transparent framework.

Further, the framework established by the Code should be consistent with and support:

(e) Local strategic planning

(f) Local asset management planning

(g) Proper option appraisal.

2.2 A framework for the internal control and self management of capital finance needs to deal with all three of the following elements:

- Capital expenditure plans
- External debt
- Treasury management

2.3 The framework includes a set of prudential indicators that need to be taken together, integrated into a coherent entity, rather than individually. The setting of the indicators will need to be a circular rather than a linear process.

2.4 The prudential indicators are designed to support and record local decision making. They are not designed to be comparative performance indicators. They are limits for the determination of the local authority, subject to any limit imposed centrally under legislation.

3 Prudential Indicators

3.1 Appendix A sets out the 18 indicators that authorities will be required to set and monitor. A further report on these will be brought back later in the year so that Members can determine the levels at which the indicators should be set.

3.2 The Chief Finance Officer is required to establish procedures to monitor performance and a process that highlights significant deviations from expectations.

3.3 The prudential indicators must be set, or revised, by full Council. In setting or revising the indicators, the authority is required to have regard to:

- Affordability eg implications for Council Tax
- Prudence and sustainability eg implications for external borrowing
- Value for money eg option appraisal
- Stewardship of assets eg asset management planning
- Service objectives eg strategic planning
- Practicality eg achievability of the forward plan

3.4 The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the level of investment in capital assets proposed means the total capital investment of the authority remains within sustainable limits.

Affordability is ultimately determined by a judgement about acceptable Council Tax levels and, in the case of the Housing Revenue Account, acceptable rent levels.

3.5 In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it/estimated for the future, together with the totality of its capital plans, revenue income and revenue expenditure forecasts for the forthcoming year and the following two years. The authority is also required to consider known significant variations beyond this time frame.

3.6 A fundamental indicator of affordability for the Council to consider in setting their forward plans is the Council Tax and housing rents that will result.

3.7 The authority should have an integrated treasury management strategy within which its borrowing and investments are managed.

3.8 The prudential system is primarily designed to be managed and controlled by local authorities themselves. However, the Government will have power under the new legislation to set a formal limit on the rate at which local authorities can increase their debt. The same power could be used to deal with any abuse of the prudential system by an individual authority, in which case a debt limit would be set by a direction issued to the authority.

3.9 **Commentary:** The objective and the principles of the Code are supported. In particular, the principal of making value for money a prime consideration in option appraisals and allowing more flexibility in determining funding sources is a marked improvement on the current system of capital controls.

3.10 For some years the Council has adopted good practice and provided forecasts of revenue and capital spending for three years in detail and six years in outline. Significant future issues, usually unquantified, have also been highlighted for Members as part of the budget process each year. The forecasts have made assumptions about tax levels and projected deficits. Some changes to the format of the projections will be required to reflect the requirement to show the impact of the forward plans on the council tax – that is, converting the projected deficits into council tax amounts. Similarly, capital appraisals will be revised to show the effect of proposals on tax and rent levels.

3.11 The Council has had a Treasury Management Strategy and Policy for some time also. The Government's retention of a power to limit local authorities' debt is understood and supported.

4 <u>Capital expenditure</u>

4.1 The local authority will make reasonable estimates of the total of capital expenditure that it plans to incur.

4.2 The local authority will make reasonable estimates of the total capital expenditure financing requirement.

4.3 In order to make these estimates, the authority will need to consider all of the financing options available and estimate their use of these. The estimates will not commit the local authority to particular methods of financing. The Chief Finance Officer will determine the actual financing of capital expenditure incurred once a year, after the end of the financial year.

4.4 **Commentary:** Forward estimates for expenditure and financing are done, although it is unusual to expect there to be unfinanced capital expenditure. This arises usually where expenditure has been incurred that will be financed by grants that are yet to be received. The Director of Finance determines the financing at the year end in accordance with approved policies.

5 External debt

5.1 The local authority will set a prudential limit for its total external debt and an operational boundary, gross of investments, separately identifying borrowing from other long term liabilities. Both the authorised limit and operational boundary need to be consistent with the authority's plans for capital expenditure and financing; and with its treasury management policy statement and practices.

5.2 The operational boundary should be based on the authority's estimate of most likely, ie prudent, but not worst case scenario. It is a key tool for monitoring. It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate.

5.3 **Commentary:** Borrowing limits are set annually and the extension of the indicator can be accommodated. Monitoring is also undertaken regularly, both internally by treasury management staff and the Director of Finance, and through reports to Members.

6 Treasury Management

6.1 The first prudential indicator in respect of treasury management is that the local authority has adopted the CIPFA Code of Practice for Treasury Management in the Public Services. The local authority will set upper and lower limits to its exposures to changes in interest rates.

6.2 The local authority will set both upper and lower limits with respect to the maturity structure of its borrowing.

6.3 Where a local authority invests, or plans to invest, for periods longer than 364 days, the local authority will set an upper limit for each forward year period for the maturing of such investments.

6.4 In all cases, the process of setting prudential indicators for treasury management should be accompanied by a clear and integrated forward treasury management strategy, and a recognition of the pre-existing structure of the authority's borrowing and investment portfolios.

6.5 **Commentary:** The Treasury Management Code has been adopted. Limits are set for borrowing and they can be extended to included investments. Borrowing limits are relatively easily set but investment limits will be much more difficult as the sums of money invested are large and are dependent upon many factors, such as achievement of expenditure plans, collection of debt and receipt of grants. In addition, the interest rates can be extremely variable and are not within the Council's control.

OTHER CONSIDERATIONS:

7 CORPORATE STRATEGY (RELEVANCE TO):

7.1 The proposals accord with the tenet of *to maintain budget stability through strong performance and resource management while accommodating the requirements of new legislation and duties.*

8 RESOURCE IMPLICATIONS:

8.1 Implementing the Prudential Code will not have any marked resource implications. Much of the Code is followed now and, although there will be a requirement to set, calculate and monitor more indicators than at present, the Code can be introduced in time for implementation next year. The proposals should allow more sensible decisions on option appraisal in the future.

8.2 However, there is considerable concern over the changes generally that the Government is introducing from next year of which the Prudential Code is part. The current system of credit approvals brings with it Government support through revenue grants. The arrangements for future support – either capital or revenue – are unknown. There is no information on how any of the proposed changes will work in detail and thus it is not possible to estimate the effect of them. Transitional arrangements that may be put in place will also be important. There is the potential for the Council to be significantly worse off than at present.

BACKGROUND DOCUMENTS:

CIPFA Prudential Code for Capital Finance in Local Authorities, Second Exposure Draft, and Preliminary Guidance, March 2003

APPENDICES:

Appendix A: Summary of Prudential Indicators

Appendix B: Proposed Response to Consultation

Summary of Prudential Indicators

Forecasts are to be for the forthcoming year and the following two years (ie 2004/05, 2005/06 and 2006/07). The authority is also required to consider known significant variations beyond this time frame.

Key Indicators of Affordability

1. Estimates of ratio of financing costs to net revenue stream**

2. Actual ratio of financing costs to net revenue stream**

3. Estimates of the impact of capital investment decisions on the Council Tax

4. Estimates of the impact of capital investment decisions on housing rents

5. Net borrowing and the capital financing requirement

Capital Expenditure

6. Estimates of capital expenditure**

7. Actual capital expenditure**

8. Estimates of capital financing requirement**

9. Actual capital financing requirement**

External Debt

10. Authorised limit

11. Operational boundary

12. Actual external debt

Treasury Management

13. CIPFA Code of Practice for Treasury Management adopted

14. Upper limits on fixed interest rate exposures

15. Upper limits on variable interest rate exposures

16. Upper limit for the maturity structure of borrowing

17. Lower limit for the maturity structure of borrowing

18. Prudential limits for principal sums invested for periods longer than 364 days

** Separate estimates will be made for the HRA and non-HRA elements

Proposed Response to Consultation

1. Do you consider that the draft Code achieves the objective of providing a framework for local authorities to demonstrate these matters when they take their decisions within the prudential framework?

2. Do you have any comments on the process and governance issues of the draft Code? In particular, are the respective roles of the Council and Chief Finance Officer correctly designated?

3. Do you agree with the approach taken in (para 3.4 and 3.5) of the draft Code?

4. Paragraphs (3.6) of the draft Code require forward estimates for the Council Tax and housing rents. Are you content to publish these forward estimates?

5. Is the meaning and definition of the capital financing requirement now clear?

6. Do you have any further comments on the detail of the prudential indicators in the draft Code?

The Code is welcomed and supported. Whilst the Code places responsibility on the Chief Finance Officer for the implementation and monitoring of the system, it will require input from service managers and Members to make it a success. Member training will be essential so that there is a proper understanding of the indicators.

The current uncertainties surrounding future Government intentions will make the setting of the indicators and the forward projections difficult and possibly meaningless. In particular, the effect of pooling of receipts, the abolition of the MRP and future Government support, both revenue and capital, all impact on future plans and thus Council Tax and rent levels.

Indicating forward estimates of tax and rent is in line with current practice but, as indicated in the preceding paragraph, the reliability of these projections is affected more by Government financing policy than by the Council. Forward projections are not able to take account of Government support with any accuracy – forward indications from the Government as part of its annual settlement would go some way towards improving the projections.