The Chartered Institute of
Public Finance & Accountancy

Capital risk metrics

Response to the consultation on local government capital risk mitigation measures in the Levelling Up and Regeneration Bill

A submission by:
The Chartered Institute of Public Finance and Accountancy

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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.

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1. Introductory comments

1.1. CIPFA welcomes this opportunity to respond to the consultation on the on local government capital risk mitigation measures in the Levelling Up and Regeneration Bill.

1.2. CIPFA understands the need for government to have more information on local authorities' capital financing activities. Recent events at a small number of authorities have highlighted the impact of the failure to adhere to the principles of prudent self-management and proper consideration of risks, particularly in relation to commercial transactions. However, as is recognised in the consultation paper, a minority of authorities have taken excessive risk in their capital strategies. Most authorities as mature public sector entities effectively apply and adhere to the principles of self-regulation in the prudential framework.

1.3. CIPFA considers it key that government considers the impact of this addition to the regulatory regime within the context of the entirety of the prudential framework including CIPFA's own Prudential Code[1]. There is a risk that if authorities see themselves as being monitored by a new set of metrics, local authorities will seek to pay more attention to these than the indicators in the Prudential Code and that the principles of self-management will be eroded.

1.4. CIPFA understands from informal discussions with government that this is not the intention. CIPFA also notes that paragraph 28 of the consultation indicates that the metrics are intended to be broadly consistent with existing metrics such as the prudential indicators in the Prudential Code, but will not necessarily be exactly the same given the different purpose. However, it would be useful to discuss with government the interaction of the different metrics and the impact that this might have on the framework as a whole.

1.5. CIPFA also suggests that wherever possible the information and indicators required by the Prudential Code are used to support the development of the capital metrics. The prudential indicators have been the subject of numerous consultative processes each resulting in significant response. They have also been subject to rigorous analysis by CIPFA's governance structure, including the then CIPFA Treasury and Capital Management Panel, which comprised experts across the UK and considered which indicators would provide the best assessment of prudence, affordability and risk against the principles of self-management.

1.6. We note that some elements of the proposed metrics already make reference to some of the prudential indicators, ie the proposals for use of the capital financing requirement, and suggest that any testing of the metrics also takes into consideration the requirements of the Prudential Code. We would be happy to provide more information and background on the Prudential Code indicators.

[1] The Prudential Code for Capital Finance in Local Authorities, 2021 edition

2. General observations on the metrics

2.1. CIPFA is pleased that the proposed measures do not use “core spending power” although we note that these are included in the alternatives. While a part of government statistical returns, “core spending power” is not routinely used in the sector and its inclusion could undermine support for the metrics if introduced.

2.2. The Capital Financing Requirement (CFR) represents the underlying need for an authority to borrow to finance capital expenditure, and is a central tenant of the prudential regime and a prudential indicator. The CFR also underpins the Minimum Revenue Provision, which is a formal part of the regime; we therefore consider this to be a useful part of the metrics. This could be supported by more context including other measures, such as reserve levels and net service expenditure, to indicate if an authority is becoming disproportionately indebted, relative to its size.

2.3. CIPFA agrees that there should be differentiation between lower and upper tier authorities. We would note with caution that this distinction is complicated by the fact that upper tier authorities are a disparate group comprising shire counties, shire unitary authorities, metropolitan districts and combined authorities. Each of these are very different in structure and are likely to have different capital financing needs as a result.

2.4. CIPFA concurs with the consultation documents’ proposals to not include waste authorities and police and crime commissioners and chief constables in the calculations because they are structured very differently to local councils. As noted, they do not have the general power of competence conferred by the Localism Act 2011 so CIPFA is of the view that should be considered separately, or not brought within the scope of these proposals.

2.5. CIPFA would underline that credit arrangements included in the metrics for non-government debt include leases. Leasing is an acceptable and often useful choice for authorities to consider when procuring assets, subject to these being tested against the principles of the prudential framework and any value for money assessments. Many authorities use leasing as a prudent way to procure and maintain equipment that is more cost-effective than purchasing assets such as vehicle fleets and IT equipment. There is a concern that an authority close to the Metric 3 threshold may make a decision to buy an asset, in an instance when leasing would be a better option for the service and/or taxpayer.

2.6. CIPFA understands and shares the concerns about arrangements such as ‘income strips’ and some complex commercial transactions, for example special purpose vehicle company structures, but considers that a metric that brings together both types of arrangements is not addressing the risk. Perhaps the capital metrics should identify these riskier financing vehicles separately.

2.7. CIPFA maintains the importance of a focus on the flow of/trends in debt and other risk metrics as well as a consideration at a single point in time. A single data point might focus on an anomalous activity such a slippage in a major project resulting in a local authority exceeding a threshold in a given year. Analysis over time is more likely to identify patterns of behaviour that are indicative of risk.

2.8. CIPFA also considers it important that these metrics are not seen as the only way that potential risk is identified and flagged. If for instance a small council incurred significant debt in any one year or at a specific point in time, an early warning system should be available within the existing capital systems and structures. The metrics would only capture such transactions retrospectively and may not allow for the appropriate and timely exercise of any new government powers and importantly remedial or corrective actions.

2.9. CIPFA recognises the difficulties in identification of commercial activity and has considered this in its recent revision of the Prudential Code. CIPFA is of the view that it would be advisable to consider what sort of commercial activity government is trying to identify and measure. Many regeneration schemes properly have a commercial element that is essential to their viability, and allowable in the latest revision of the Prudential Code. That said, the nature of some of these schemes means they contain commercial risk.

2.10. CIPFA would seek to understand whether the metrics are trying to capture more overt commercial activity, such as acquisitions of assets unrelated to or conflicting with the authority's placemaking remit. Indicator 2a uses 'Trading expenditure'; CIPFA considers that this would capture purely commercial activity. The 2021 Prudential Code introduced net commercial and service investment income to net revenue stream as an indicator of reliance on such activity. This might be a better measure of broader commercial activities if the intention is to identify all capital expenditure with a commercial element. As noted above we would be concerned if any of the metrics adopted 'core spending power'.

2.11. Some of the proposed measures appear to be trying to measure similar concepts to those in the Prudential Code. CIPFA suggests that the prudential indicator financing costs to net revenue stream (or net service expenditure) would produce a measure of a local authority's debt as compared to the financial resources at the disposal of an authority.

2.12. The Treasury Management Code[2] also recommends the maturity structure of debt – as an indicator. The Treasury Management Code recommends a maturity structure that is closely aligned to an authority's Liability Benchmark – in practice this is closely related to its CFR. We think a metric that is related to these indicators would be more informative and we would be happy to discuss this in more detail.

2.13. CIPFA is interested in how the results of the metrics will be used in practice and communicated to local authorities. How will authorities be assessed and monitored? It will be important for there to be clarity about what will become the thresholds identified by the Act (whether this will be assessed against all metrics, groups of metrics or individual metrics). Will there be any consideration of those that might be deemed at risk, and will local authorities be notified if they are in an 'at risk' category to allow time for remedial action? How will these decisions take into account the underlying financial resilience of an authority and the time available for any remedial activity to have the required effect?

2.14. It will be important for local authorities to understand what procedures are going to be adopted and when. For example, where there might be early communications with the authority with an intention to understand the context before any published warning or intervention. It would also be useful to understand whether OFLOG (the Office for Local Government) would have any particular role with the establishment and maintenance of the metrics.

[2] Treasury Management in the Public Services Code of Practice, 2021 edition.

2.15. Any form of measurement against which a local authority is assessed will skew behaviour in that direction. This might be appropriate or result in local authorities becoming overly prudent, and it might equally result in risk adverse positions that stifle important capital investments in areas such as regeneration and housing. The theme of unintended consequences should be explored as part of the wider consultation activities with the local government sector to ensure perverse incentives are avoided. CIPFA would not wish to see local authorities skewing their activities to suit these returns, especially if it means making decisions that do not provide optimal value, such as the example cited in paragraph 2.6. There is also the related issue of data quality, though CIPFA acknowledges that the metrics themselves will probably lead to improvement in this area. CIPFA would question whether data improvement be a task that falls within the remit of OFLOG.

2.16. CIPFA's Resilience Index (RI) considers many aspects of capital risk that this regime would seek to address. We would welcome a dialogue about how the RI could have a role within this regime.

2.17. We think caution should be exercised and further consideration given to some metrics that might be seen as "punishing" local authorities for decisions that were made in good faith and in line with government policy of the time. Including credit arrangements as a primary measure may be an example of this.

2.18. CIPFA welcomed the opportunity to attend one of the roundtables on the capital metrics where it was highlighted that there was a working assumption that the data sets would be broadly normally distributed. CIPFA is not convinced that this is the case. For example, the second metric is likely to lead to many authorities with a metric that is close to zero and a peak of authorities at a higher number. It will be hard to establish thresholds of results using purely statistical techniques and the context of the results will need to be considered.

Response to the consultation questions

3.1. Risk metric one: the total of a local authority's debt (including credit arrangements) as compared to the financial resources at the disposal of the authority

1(a) Capital Financing Requirement/Total Service Expenditure (TSE)

Question	Response	Explanation
Considering the objectives set out in this document, and the principles set out, do you agree that the proposed calculation (calculation 1(a)) should be the basis for this metric?	Partially agree.	The measurement does give an indication of local authority's indebtedness against the financial resources available to it. However, there are limitations, which in CIPFA's view need to be addressed: • As well as net service expenditure, should reserves also be relevant to the financial resources at the disposal of the authority? Is there a way that they could be incorporated into a metric? • Assuming this metric would be based on the Capital Financing Requirement (CFR) for both HRA and GF debt, would the metrics need to be reported and considered separately? Total Service Expenditure as defined by the RO forms does not include HRA expenditure, so for consistency the HRA part of a local authority's CFR should also be excluded. • CIPFA would highlight that combined authorities have different resource structures and needs compared to other upper tier authorities such as shire counties (higher levels of debt, with lower levels of service expenditure) but their finances are not deemed to be subject to more risk. CIPFA would ask how any metric might take this into account? • Once IFRS 16 *Leases* is implemented in 2024/25, it is likely that lower and single-tier authorities will appear to experience a sudden jump in indebtedness, as previous operating leases come onto the balance sheet as "credit arrangements". Will this be considered in context when comparing 2024/25 results to 2023/24, given that it represents no substantive increase in their indebtedness or risk?

Are any of the alternative calculations more appropriate than the proposed calculation?	No	CIPFA is of the view that: 1(b) and 1(e) suggest the use of core spending power, which is a figure highly dependent on the annual settlement and not determinable by the individual authority. 1(c) is only of value as a time-series. This may have been distorted in 2021/22, when capital programmes would have “caught up” having been paused for part of 2020/21 due to the COVID-19 pandemic. 1(d) is very close to the existing prudential indicator “Financing Costs versus the Net revenue stream”. CIPFA would suggest that consideration be given to incorporating this measure as one of the capital metrics, since all authorities within the scope of this proposal are already required to calculate, publish and report it.
Considering the objectives set out in this document, and the principles set out, is there an alternative calculation/s you think is more appropriate?	Yes	In accordance with our response above we would suggest that a metric be introduced which excludes the housing element of the CFR, therefore: Capital Financing Requirement (less CFR for the Housing Revenue Account) / Total Service Expenditure (TSE)

3.2. Risk metric two: the proportion of the total of a local authority's capital assets which is investments made, or held, wholly or mainly in order to generate financial return

2(a) Investment income/Total Service Expenditure

Question	Response	Explanation
Considering the objectives set out in this document, and the principles set out, do you agree that the proposed calculation (calculation 2(a)) should be the basis for this metric?	No	CIPFA would question whether the intention of this measure is to assess the level of leveraged income an authority has, or its reliance on investment properties? The proposed metric would measure the level of reliance that a local authority has on investment and service property income to fund its services. However, it would not necessarily measure the proportion of an authority's property portfolio that are investment properties. Furthermore, there are authorities that are debt-free that also have non-treasury investments that yield significant income streams, so it would not necessarily be a good measure of leveraged income. CIPFA is of the view that the components of this metric may have been interpreted differently by local authorities.
Are any of the alternative calculations more appropriate than the proposed calculation?	No	CIPFA is of the view that: 2(b) uses Core Spending Power, which is not an appropriate measure (see previous comments). 2(c) may encounter the same data quality issue related to the interpretation of the components of this metric, as well as the limitation that it doesn't consider the full portfolio of investment properties as it only considers in-year capital expenditure. 2(d) may encounter similar issues described for Metric 1 in relation to combined authorities as compared to other upper tier authorities, as they are characterised by low TSE relative to their capital programme.

Considering the objectives set out in this document, and the principles set out, is there an alternative calculation/s you think is more appropriate?	Yes	CIPFA is of the view that there might be an alternative: the CIPFA Prudential Code includes an existing prudential indicator that was introduced in 2021, ie net income from commercial and service investments to net revenue stream. This would have the same issue as the primary measure in that it does not consider the full portfolio of investment properties. Another alternative is investment property assets as a proportion of property, plant and equipment assets from the capital returns, which might address the metric more directly. It is notable that this would also have its limitations, as it would rely on a different data source and may not be a useful indicator of risk.

3.3. Risk metric three: The proportion of the total of a local authority's debt (including credit arrangements) in relation to which the counterparty is not central government or a local authority

3(a) Non-government debt/Total borrowing

Question	Response	Explanation
Considering the objectives set out in this document, and the principles set out, do you agree that the proposed calculation (calculation 3(a)) should be the basis for this metric?	Partially agree	The proposed measure will give an indicator that satisfies the risk metric. However, CIPFA is not clear about this metric's value in assessing risks generated by the activities measured: • CIPFA would question whether non-government debt is inherently riskier than government debt. Market lenders tend to conduct in-depth due diligence on the borrower's ability to pay so the presence of non-government debt cannot, in isolation, be seen as an indicator of risk. • Further consideration of whether and how these metrics might be used is needed. How debt is structured is more pertinent when considering risk. CIPFA is of the view that non-government debt, such as some Lender Option Borrower Option (LOBO) structures and index-linked instruments, may include more inherent risk. Whereas a 'vanilla' fixed rate non-government debt instrument is no riskier than a PWLB debt structured in the same way. In attempting to achieve compliance with this metric, an authority close to the threshold may make suboptimal "buy or lease" decisions, given that leasing would increase their non-government debt, but in many cases would tend to be the less risky option that best suits the needs of the service (such as vehicle fleets and large office equipment). CIPFA would also question how a threshold to assess risk may be set. It would be challenging to set a threshold that is meaningful, in terms of capturing possible risk incurring activities, but not set so low that it creates significant workload to determine context. The issue of assessing the threshold here will be compounded as IFRS 16 will bring the majority of leases into this measure as opposed to solely finance leases under the current reporting requirements.

Are any of the alternative calculations more appropriate than the proposed calculation?	No	CIPFA is of the view that: • Alternative 3(b) would, like the primary indicator, include leases as discussed in the introduction to this response the use of, for example leases, is a legitimate procurement option. This would penalise authorities that have decided to lease assets and encourage local authorities to restrict future procurement decisions to non-leasing activities; potentially leading to suboptimal procurement decisions. Furthermore, many authorities will have large legacy PFI arrangements, which were supported and encouraged by previous government initiatives. CIPFA would note that there are significant risks in such schemes but measuring their totality would 1) penalise authorities for previously acceptable decisions and 2) not directly assist local authorities in managing and understanding these risks, which is where the focus should be. • 3(c) the current description would presumably include debt servicing costs of all debt in the numerator and only non-government debt in the denominator; it is not clear what value this measure would have. • 3(d) would capture refinancing risk and any authorities that carry a significant proportion of their borrowing short-term would be disadvantaged, though arguably this would identify the risks inherent in short-term debt. Of all of these options, this is actually of the most value in determining risk, but it would not serve the objectives of the metric as described in the bill.
Considering the objectives set out in this document, and the principles set out, is there an alternative calculation/s you think is more appropriate?	Yes	The liability benchmark to maturing debt (as implemented in the 2021 Code) uses existing datasets that may capture riskier debt structures. Local authorities should have an effective understanding of their existing debt maturity profile; this will enable them to understand the risks in the debt profiles over time. CIPFA does recognise that this measure will not satisfy the objectives of the metric to measure the proportion of non-government debt as specified by the Bill.

3.4. Risk metric four: The amount of minimum revenue provision charged by a local authority to a revenue account for a financial year

4(a) Reported MRP/CFR (less CFR for the Housing Revenue Account)

<table>
<tr><th>Question</th><th>Response</th><th>Explanation</th></tr>
<tr><td>Considering the objectives set out in this document, and the principles set out, do you agree that the proposed calculation (calculation 4(a)) should be the basis for this metric?</td><td>No</td><td>The proposed measure will address the objective in so far as it will indicate what an authority has set aside as a time series. It is welcome that this is presented as a time series, since it will allow the user of the data to distinguish between an authority that may in a single year be correcting previous overprovision – which is the only circumstance that allows a zero or negative charge in any one year.
However, there is an argument that there is already adequate regulation in place concerning this risk area:
The current statutory guidance on Minimum Revenue Provision (MRP) specifies that a local authority cannot be a negative charge.
The proposed revision to the MRP regulations will tighten up on areas where authorities might employ practices that lead to the under-provision for MRP.
There may be a data quality issue – anecdotal evidence suggests that capital and revenue returns have not, in practice, had the same MRP figure. Data quality will need to be considered, though CIPFA recognises that the introduction of the risk metrics will encourage improvements in data quality. As noted in the introduction, there is a question of where the threshold might be set and what this will represent to an authority. Some authorities might legitimately have low MRPs as a proportion of their CFR; would this be taken into account?
Authorities may have taken decisions to reduce their MRP in accordance with Regulation 23 (b) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended to set aside capital receipts in a year to repay debt (the principal of any sum borrowed) to reduce the budgetary impact of the MRP. This may skew their results against other local authorities.</td></tr>
<tr><td>Considering the objectives set out in this document, and the principles set out, is there an alternative calculation/s you think is more appropriate?</td><td>Yes</td><td>MRP + capital receipts set aside to repay debt in accordance with Regulation 23(b) / CFR (less CFR for the Housing Revenue Account)</td></tr>
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4. Concluding remarks

4.1. CIPFA appreciates that this is a difficult area where action is required by government because of the significant failures and behaviours at some authorities. CIPFA understands the need for metrics to identify patterns of behaviour and potential for innovative financing activities to expose the local government sector to unwelcomed commercial and reputational risk. CIPFA would advocate a set of metrics that complement and wherever possible use as their starting point the prudential indicators. We would welcome the opportunity to work with government to develop these.

4.2. Government will be aware that CIPFA keeps the Prudential and Treasury Management Code under constant review and will discuss with government once it has finalised its decisions on the indicators whether there should be any revisions to the Prudential Code to harmonise with the metrics if possible/necessary and reduce the reporting burdens of local authorities.