The Prudential Code for Capital Finance in Local Authorities

Consultation responses and proposed changes

Executive summary

CIPFA is pleased to publish its response on the review of The Prudential Code for Capital Finance in Local Authorities (2017) (Prudential Code). CIPFA is grateful to the sector for the healthy response rate, with over 100 responses provided for each code consultation.

As guardians of the Prudential Code, CIPFA will ensure it is strengthened. Following the significant risk taken to protect this system by a few local authorities with public funds, the proposals outlined in this consultation clearly address that borrowing for yield only is a risk to prudent investment. Without these strengthened provisions, local authorities risk further government intervention in 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 that either push the boundaries of the Prudential Code or intentionally misinterpret its provisions.

Following a review of each response we have received, the changes we will take forward into a revised Prudential Code are as follows:

- ‘Paragraph 45’ will be updated and revised to include the proposals for strengthening the Prudential Code in the consultation.
- CIPFA will include proportionality as an objective in the Prudential Code, and those further provisions are included so that an authority incorporates an assessment of risk to levels of resources.
- CIPFA will provide clarification and definitions to define commercial activity and investment. The amendments to the Prudential Code will be consistent with the proposals outlined for paragraph 45 – that the purchase of commercial property purely for profit cannot lead to an increase in capital financing requirement (CFR).
- CIPFA will introduce the liability benchmark as a treasury management indicator for local government bodies and explore a similar indicator for cross-sector organisations.

CIPFA intends to publish the revised Prudential Code in December 2021.

Consultation extract – borrowing in advance of need

In the last five years, there has been an increasing trend in authorities purchasing 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:

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* (2018) to assist local authorities in investment decisions in this area.

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

CIPFA would note that the provisions in 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

…

45 **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.~~ Therefore, local authorities **must** not borrow to fund solely 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 properties. Authorities should also consider carefully whether they can demonstrate value for money in borrowing and can ensure the security of such funds. For examples on how to assess this, refer to *Prudential Property Investment* (CIPFA, 2018).

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

Response	Number of responses
Agree or suggested amendments	56
Disagree	42

Total responses: 98.

Consultation response summary:

The consultation sought views on the first sentence of paragraph 45 and expanded clarification proposed within the Prudential Code. Responses overall are in favour of agreeing with the proposals or with suggested amendments to the clarification.

Respondents agreed that commercial yield is allowed when it is ancillary to the primary reason for the scheme, and paragraph 45 states that authorities must not borrow more than or in advance of their needs in order to profit from the investment of the extra sums borrowed. The respondents' views are that this is consistent with the new guidance on Public Works Loan Board (PWLB) borrowing published in November 2020 and would not affect planned capital, investment or treasury management activities.

The replacement of 'purely' with 'primarily' means authorities may invest in advance of use of any borrowing to fund core functions such as economic regeneration. It should remain the case that a strong audit trail is available to demonstrate the purpose of borrowing in case this is challenged by auditors. The wording does not remove value for money considerations when entering borrowing. This means that if there is a case to borrow in advance of a specific and identified need to secure more favourable rates of interest, this is permissible.

Respondents who disagreed made the following observations.

As specified in the Prudential Code, local authorities have considered the CFR to be their underlying need to borrow. This is consistent with the definition of borrowing in advance of need in the Scottish Government guidance. If paragraph 45 is to be retained in the revised Prudential Code, it is essential that a precise definition of 'needs' is given. Clarity on what constitutes 'profit' from the investment will also be helpful, without preventing authorities from taking good treasury management decisions to borrow when interest rates are low.

Respondents commented:

The use of the word 'primarily' instead of 'purely' takes a statement that was quite clear in its meaning to one that is now open to greater interpretation.

They were of the view that clear definitions of the terms 'needs' and 'investment' would also be essential. Some authorities define 'need to borrow' as meeting cash flow requirements up to the capital financing requirement. Borrowing is not undertaken on a project-by-project basis but as part of the treasury management function of day-to-day cash flow management. 'Investments' take many forms, and clear definitions of what is and isn't acceptable under the term 'primarily yield generating' is critical.

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 their needs purely in order to profit from the extra sums borrowed"?

Response	Number of responses
Agree or suggested amendments	41
Disagree	51

Respondents' comments:

The consultation proposed changes to paragraph 45 to further clarify the position of "borrowing in advance of need purely in order to profit from the extra sums borrowed".

Respondents in favour of the changes agreed, but the consensus is clear that more clarification on the definitions of 'need' and 'investments' is required. Currently, 'need' is only defined as the need to finance the capital financing requirement, which at present could also be increased by purchasing a commercial investment.

Respondents also agreed with the need to strengthen the Prudential Code and that the current wording has "not prevented a minority of councils taking disproportionate levels of commercial debt to generate yield by misinterpreting the Prudential Code or not having regard to its provisions". The additional wording, which adds "local authorities must not borrow to fund primarily yield-generating investments", provides clear guidance while still allowing authorities to make their own judgement regarding what constitutes 'primarily'. It appears that respondents support the proposals as an appropriate change.

Comments in disagreement with the proposed changes mainly requested further clarification or clearer definitions and raised the issue that to purchase a non-current asset (or commercial property) depletes cash resources. This in turn leads to a need to borrow. The respondents indicated that paragraph 45 incorrectly infers that the money is initially borrowed and then a secondary purpose is sought for money raised.

Responses also requested that changes could go further and clarify what constitutes profit and need. The draft paragraph 46 is unclear, in that the authority should also consider carefully whether they could demonstrate value for money in borrowing.

CIPFA response to questions 1 and 2:

CIPFA will continue with the proposed clarifications that are intended to protect the public purse and avoid misinterpretation of the Prudential Code's provisions.

CIPFA has provided a revised draft of paragraph 45 below, taking into account the respondents' views:

EXTRACT OF PARAGRAPH 45 FROM THE PRUDENTIAL CODE WITH PROPOSED AMENDMENTS

SECTION SIX

Prudence and prudential indicators for prudence

…

45 ~~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. Therefore, local authorities must not borrow to fund solely yield-generating investments.~~

45 Authorities under legislation can borrow and invest for the following purposes:

- Any function of the authority under any enactment.
- For prudential financial management.

46 The Prudential Code considers legitimate examples of prudent borrowing to include:

a) financing capital expenditure primarily related to the delivery of a local authority's functions

b) temporary management of cash flow within the context of a balanced budget

c) securing affordability by removing exposure to future interest rate rises

d) refinancing current borrowing, including replacing internal borrowing, to manage risk or reflect changing cash flow circumstances.

47 The Prudential Code determines certain acts or practices that are not prudent activity for a local authority and incurs risk to the affordability of local authority investment:

- An authority must not borrow to invest for the primary purpose of commercial return.
- It is not prudent for local authorities to make any investment or spending decision that will increase the CFR, and so may lead to new borrowing, unless directly and primarily related to the functions of the authority and where any commercial returns are related to the financial viability of the project in question.
- These principles apply to prudential borrowing for capital financing, such as externalising internal borrowing for the primary purpose of commercial return.

48 The UK government's rules for access to PWLB lending require statutory chief finance officers to certify that their local authority's capital spending plans do not include the acquisition of assets primarily for yield. This reflects a view that local authorities' borrowing powers are granted to finance direct investment in local service delivery (including housing, regeneration and local infrastructure) and for cash flow management rather than to add gearing to return-seeking investment activity. Since:

a) access to the PWLB is important to ensure local authorities' liquidity in the long term, and

b) gearing investment always increases downside risks

local authorities should not borrow to finance acquisitions where obtaining commercial returns is a primary aim.

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?

Response	Number of responses
Agree	45
Disagree	32
Neutral	19

CIPFA requested respondents to comment on the proposal to add proportionality to the objectives within the Prudential Code, especially regarding commercial investments.

Overall, respondents are in favour of including proportionality for capital expenditure generally and for commercial investment, particularly as this is an important consideration. Their views appear to be it is appropriate that this should be explicitly included in the objectives of the Prudential Code.

Respondents have, however, requested further clarification of the interpretation of proportionality and commented that it could be placed in the context of risk to the authority in relation to its risk appetite.

CIPFA response:

Following the positive response to the proposals in the consultation paper, it is recommended that CIPFA will include proportionality as an objective in the Prudential Code, and that further provisions are included so that an authority incorporates an assessment of risk to levels of resources.

On the matter of clarification with regard to the position of commercial proportionality, CIPFA is of the view that while local authorities should not be investing in assets primarily for commercial yield, it is recognised, for example, that commercial activity is often a component of successful regeneration projects. We therefore propose that local authorities assess the proportionality of the commercial risk of all projects, including regeneration, to quantify the risk to their resources. As a simple example, if a local authority has reserves of £20m and carries commercial risk of £50m, this would be considered disproportionate. Please note that this is extensively explored in CIPFA guidance *Prudential Property Investment* (2018).

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?

Response	Number of responses
Agree	44
Disagree	28
Neutral	27

Respondents generally agree that the introduction of a specific objective around commercial investment is useful, with the intention to embed good practice across local authorities irrespective of the type of capital investment that is taking place. Respondents commented that, as set out in the proposed drafting, commercial investments should follow the same process, and to further strengthen the guidance, wording could be added to state that a commercial return is not to be used to 'shortcut' other protocols contained within the guidance.

Respondents consider it would be helpful to define 'commercial investment', so that this position is understood and consistently applied by all users of the Prudential Code. Also, in light of recent high-profile failings connected with commercial investment, respondents suggested that consideration be given to the addition of a comment on the principles of good governance and informed decision making. Respondents also believe it would be useful if CIPFA could provide examples of what an 'acceptable commercial investment' is:

- Purchase of a commercial property purely for profit cannot lead to an increase in CFR and is considered unacceptable.
- An economic regeneration scheme that has clear policy objectives, part of which results in commercial income, is considered acceptable.

CIPFA response:

CIPFA will provide clarification and definitions to define commercial activity and investment. The amendments to the Prudential Code will be consistent with the proposals outlined for paragraph 45 – that the purchase of commercial property purely for profit cannot lead to an increase in CFR and is considered unacceptable – and provide clear guidance that an economic regeneration scheme that has clear policy objectives, part of which results in commercial income, is considered acceptable.

Question 5: Do you agree with the proposal to add sustainability and ensure 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.

Response	Number of responses
Agree	27
Disagree	62
Neutral	11

Respondents were asked for their views on the proposal to add sustainability and ensure 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.

The proposal comments were mostly opposed to this. Respondents recognised that sustainability/climate change is an important issue for local authorities alongside numerous strategic issues such as education and social care. However, they do not agree with the proposal to add it to the Prudential Code, as this proposal mixes subjective, policy-related issues with the objectivity of the Prudential Code. The Prudential Code has been structured to ensure that the policy framework within an elected body is structured in a professional and objective way to ensure policy decisions are prudent, sustainable (longevity, not climate change, etc) and affordable.

Many respondents commented that sustainability/climate change is not directly a finance/S151 (or in Scotland S95) function, but rather a wider corporate issue that is the responsibility of the senior management team and elected members. It is also an issue that reflects a wide spectrum of ideas and ideology, which cannot be properly reflected in an accounting code (this is not an accounting code). An example cited was that the Prudential Code does not incorporate education or social care issues, just the impact of those services and policy-led capital decisions on the overall finances of the authority. The Prudential Code is an objective and professional code that should be removed from any political or subjective considerations.

CIPFA response:

CIPFA believes sustainability is an important issue and will provide additional direction to support sustainable behaviour in the guidance without prescription.

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

Response	Number of responses
Agree	80
Disagree	5
Neutral	7

Overwhelmingly, respondents agree that the current Prudential Code objectives continue to be relevant, and that they currently provide an understandable set of indicators to enable decision makers and those charged with governance to ensure that borrowing is undertaken responsibly and the cost of borrowing remains affordable.

CIPFA response:

The sector continues to view the Prudential Code as relevant, professional and an objective framework designed to ensure capital plans are prudent.

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

Response	Number of responses
Agree	60
Disagree	8
Neutral	22

Respondents were asked to provide views on whether they believe the provisions in the Prudential Code achieve their objectives. Most respondents agree that they do, and this is a substantial improvement on the older, more restrictive system.

The application of the Prudential Code appears to work in practice as a decision-making aid, while ensuring the safety of public funds. Clearly, there have been differing opinions on the precise meaning of elements of the Prudential Code, but this is an interpretation issue rather than a fundamental issue with its concept.

CIPFA response:

CIPFA recognises that elements of the Prudential Code may require further definition and clarification, and the secretariat would welcome views on how the objectives might be updated.

Question 8a: Do you consider there are any areas that are not fully covered by these objectives? If yes, please expand, describing how these areas could be covered within the objectives.

Response	Number of responses
Yes	41
No	49

Respondents have provided suggestions on a small number of areas of the Prudential Code that have not been fully covered within the current objectives. Suggestions included:

- Development of the Prudential Code to include formal monitoring of balance sheet resources: this would help members and officers to understand the resources underpinning treasury management investment balances and/or being used to maintain an under/internal borrowing position.
- An objective to state that capital expenditure should align to the council's corporate objectives: this will then make it hard for councils to borrow and spend on assets outside of their local area.

CIPFA response:

CIPFA will review these proposals and consider how the Prudential Code might be updated. The secretariat would seek the views of the panel on how this might be undertaken.

Question 8b: 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?

Response	Number of responses
Agree	84
Disagree	5
Neutral	2

Respondents were asked for their views on the proposals to include the status of the Prudential Code within the body of the code itself. Respondents substantially agree it is sensible to include the status of the Prudential Code within the body, as with the Treasury Management Code.

CIPFA response:

CIPFA will implement the proposal.

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?

Response	Number of responses
Agree	50
Disagree	20
Neutral	25

Respondents were asked about 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. Most respondents agreed the clear identification of risk to members is important and how future events could affect the affordability.

CIPFA response:

As covered in previous responses, CIPFA will provide clarification on the definitions of investments primarily for yield and those related to regeneration activities within the final Prudential Code and guidance.

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.

Total responses: 80.

The consultation invited suggestions for how the prudential indicators could be improved in order that they might provide additional assurance for public accountability. The main themes of the suggestions are as follows:

- There could be a requirement for indicators to be reported quarterly. It is neither appropriate nor sufficient for indicators to be reported once a year within the treasury management outturn report.
- The benchmarking of debt against similar classes of authority would be a useful indicator for elected members.
- Respondents are of the view that it is important the indicators are understandable, and if the number of indicators are increased or become more complex, there is less chance of this being the case.

CIPFA response:

CIPFA will consider these responses and would welcome any further comments from the panel on the proposals and how the Prudential Code and its guidance might be updated.

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

Response	Number of responses
Agree	23
Disagree	55
Neutral	8

Respondents were invited to comment on the proposal of the addition of the new indicator for external debt to net revenue stream to assess proportionality.

Overall, respondents did not agree with the proposal to add a new external debt indicator. They were of the view that this can be a misleading indicator. Respondents suggested that CFR to net revenue would be far more meaningful.

The respondents who did agree with this proposal were of the view that this indicator should help a local authority to better understand how the relationship of debt to resources is used to support service expenditure. They also agreed that it adds to the overall knowledge about financial sustainability.

CIPFA response:

CIPFA will not implement this proposal, but it will recommend in guidance that local authorities consider introducing this or similar indicators as local indicators. The panel's views are sought on this issue.

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?

Response	Number of responses
Agree	38
Disagree	32
Neutral	27

Respondents were invited to comment on the addition of the new indicators for net income from commercial and service investments to net revenue stream to assess proportionality.

Respondents agreed that this proposed indicator provides a contextual assessment of the proportionality of income from commercial and service investments. However, they requested that CIPFA provide additional guidance and commentary on how this indicator should be interpreted.

Respondents commented that a high ratio of commercial and service investment income as a proportion of the net revenue stream might suggest an indicatively greater exposure to risk in an increase stream. An annual fluctuation in this indicator may prove difficult to interpret, as it could indicate a declining exposure to risk or that a risk has emerged where loss of income has occurred against a recent commercial or service investment.

Respondents also suggested it might be worth considering complementing this associated measure with an indicator of gross income from commercial and service investment as a proportion of the associated capital financing costs linked to the borrowing to fund that investment.

Some responses commented that any indicator that looks at proportionality on an annual basis is likely to omit this critical element in supporting decision making, and therefore respondents proposed that the indicator should include a backward-looking element to show the variability of commercial and service investment income over time. For example, if the income compared to net revenue stream was relatively high but historical analysis showed that the income was robust, this would give some comfort to members and the public about the risks associated with that income.

CIPFA response:

CIPFA is of the view that it will implement the new indicator, with the addition of comparing this to levels of reserves to provide context on the financial sustainability of the local authority.

Further to this, the indicator should be providing a narrative on the security of the commercial income as suggested to review its assessment of the levels of risk attributed to the commercial revenue.

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

Response	Number of responses
Agree or suggested amendments	46
Disagree	45

Total responses: 91.

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

Response	Number of responses
Prudential	18
Treasury	28
No preference or neither	55

Respondents were invited to consider the implementation of the liability benchmark as an indicator. They raised concerns that the liability benchmark as presented is a complicated analysis that members would likely have trouble understanding. Further, the requirement to calculate many years beyond the planned capital programme means that the long-term forecast would be unreliable to use as a tool for decision making and the results could be misleading.

Respondents believe an indicator of this nature would be useful but would prefer the ability to tailor it to allow for assumptions that would better fit their own situation and long-term capital plans.

CIPFA response to questions 13 and 14:

The liability benchmark is an essential risk management tool. The optimum position is for total borrowing to be on the liability benchmark line. Borrowing above that level will be reflected in increased investment balances and introduce the cost of carry and additional credit risk implications, although this may be needed to anticipate interest rate movements and secure affordable borrowing.

CIPFA will implement the liability benchmark as a treasury indicator and will provide substantial guidance on the use and creation of a liability benchmark to enable local authorities and other organisations to use this effectively.

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

Response	Number of responses
Agree	19
Disagree	73
Neutral	6

Respondents were invited to comment on the removal of the prudential indicator gross debt and the CFR on the basis that it is included as part of the liability benchmark, which is to be introduced as a prudential indicator.

Overwhelmingly, respondents do not agree with the removal, on the basis that the liability benchmark should not be viewed as a replacement for the gross debt to CFR indicator and would not substitute the control offered by this indicator.

CIPFA response:

CIPFA will not remove the prudential indicator gross debt and CFR.