

## COMMENTARY ON REVISED DRAFT PRUDENTIAL CODE — PCSG 19 02/03

### INTRODUCTION

- 1 This revised draft of the Prudential Code – PCSG 19 02/03 – is the first full revision of the 2001 exposure draft of the Code and is work in progress towards the second exposure draft of the Code.
- 2 The revised draft has been updated in line with decisions taken by the Prudential Code Steering Group at their meeting in July when they considered issues raised in response to the 2001 exposure draft. Experiences from road testing to date have also been taken into consideration in this redraft.
- 3 Further amendments, in line with developing primary and secondary legislation, will need to be made in the future. Also, the second round of workshops for local authorities who are roadtesting the draft Code are taking place in November and the results of these will need to be considered.
- 4 The Prudential Code Steering Group is asked to consider this revised draft together with the detailed commentary below on the changes that have been made.
- 5 This revised draft is also being taken to the October meeting of the Treasury Management Panel and a copy of the report for the TMP is appended to this paper.

### OBJECTIVES OF THE PRUDENTIAL CODE

- 6 Widespread support has been expressed for the objectives of the December 2001 exposure draft of the Prudential Code (the 2001 consultation draft). Moreover, most of the responses received to the 2001 consultation draft who responded to the question – Does the [draft] Code achieve the objectives set out in paragraph 1? said either that the Code achieves the objectives set or that it generally does so.
- 7 The objectives included within the 2001 consultation draft have therefore been retained within the current redraft. Some minor amendments have been made in the accompanying text.

### PRUDENTIAL INDICATORS FOR CAPITAL EXPENDITURE

- 8 Short titles have been included within the text for all of the prudential indicators for clarity and ease of reference.
- 9 For completeness, a new prudential indicator to record actual capital expenditure has been added in the current draft.

- 10 The title ‘capital expenditure unfinanced’ used within the 2001 consultation draft was unclear, confusing and conveyed too negative an impression. At their July meeting, the PCSG agreed that an alternative term should be used. Suggestions made include:
- capital financing requirement
  - capital expenditure not yet charged to revenue
  - capital expenditure to be charged to revenue in future years
  - underlying need to borrow
  - underlying need to borrow for a capital purpose
  - underlying capital borrowing requirement
  - underlying borrowing requirement
  - capital credit requirement
  - long term capital requirement
  - capital expenditure on which the decisions about financing are yet to be made.
- 11 At its meeting on 11 July, the PCSG expressed support for the term ‘capital financing requirement’ whilst requesting further options. Within the current draft, all references to ‘capital expenditure unfinanced’ have been changed to ‘capital financing requirement’. In addition, the point is made that the capital financing requirement will reflect the underlying need to borrow.

#### PRUDENTIAL INDICATORS FOR EXTERNAL DEBT

- 12 The proposal to have three levels of indicator for debt rather than one was adversely commented on in a significant number of responses to the 2001 consultation draft. A common comment was that there is no need (or that there is a need to explain the need for) three different levels in relation to debt. Furthermore, it was evident at the first set of road testing workshops that there is confusion about what is meant by the different levels proposed in the 2001 consultation draft without further explanation.
- 13 At its July meeting the PCSG agreed that there is a need for the two levels of indicator in relation to external debt, referred to in the 2001 consultation draft as ‘authorised limit’ and ‘estimate of maxima’, but that their names should be reconsidered, in particular the reference to ‘maxima’.
- 14 Both ‘estimates of maxima’ and ‘authorised limits’ will be based on the authority’s plans. In the 2001 consultation draft, the third level of the ‘prudential limit’ could be either equal to or greater than the ‘authorised limit’. It was introduced because it was considered that some local authorities might wish to authorise a limit that is less than it could, given its economic circumstances, prudently set. The PCSG agreed with comments received in response to the 2001 consultation draft that there is no need for the previously proposed third level for this purpose. It had also been suggested that having a third level of indicator in relation to debt builds in a contingency to address risk. However, the PCSG decided that there should not be requirement in the Code for a third level of debt in order to consider risk, but that risk should be taken into account when setting the two remaining indicators in relation to debt and that this should be made clear in the accompanying text.

- 15 The following action has been taken in the current draft with respect to the three levels of indicator for debt in the 2001 consultation draft.
- (a) The number of levels required in the Code have been reduced from three to two.
  - (b) The short title proposed for the first level is ‘authorised limit’. This prudential indicator is a limit beyond which the Council has not authorised itself to go.
  - (c) The short title proposed for the second level is ‘operational boundary’. This prudential indicator is not intended as an absolute limit, but a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action.
  - (d) A specific cross reference has been added to other provisions of the Code, in particular to the matters the authority is required to take into account, process and governance issues, and definitions to be used.
  - (e) The explanatory text has been changed to reflect the discussion at PCSG.
- 16 The ratio of financing costs to revenue stream has been removed from this section of the Code and is now addressed in the section on affordability.

#### PRUDENTIAL INDICATORS FOR TREASURY MANAGEMENT

- 17 A significant number of the responses to the 2001 consultation draft commented either that there were too many prudential indicators for treasury management or that reliance on the CIPFA *Code of Practice for Treasury Management in the Public Services* (the TM Code) is sufficient in itself without further indicators.
- 18 The PCSG considered this at its meeting on 11 July 2002. The PCSG noted that the prudential indicators for treasury management in the 2001 consultation draft address key areas of risk for public money:
- variable rate interest exposures
  - fixed rate interest exposures
  - maturity of borrowings
  - investment of principal sums.
- 19 The PCSG considered whether, under the prudential framework, decisions on the strategy (limits) for such areas of risk:
- are not required at all
  - should be delegated to the treasury management practitioner
  - should be delegated to the Chief Finance Officer
  - should be decided by the Authority.

The PCSG decided that these limits should be recommended by the Chief Finance Officer and considered and approved by Members. The Steering Group were of the view that it is important that this is the case; also that the limits to be considered by Members should focus on the key areas. The PCSG agreed with commentators that there were too many prudential indicators proposed for treasury management within the 2001 consultation draft.

20 Several respondents commented that the requirement for treasury management indicators should be part of the TM Code rather than the Prudential Code. At its meeting on 11 July the PCSG was asked to recommend on this matter to the Treasury Management Panel.

21 The PCSG agreed that the factors to be taken into consideration are:

- the TM Code deals with treasury management issues
- the TM Code is cross sectoral whereas the Prudential Code will apply to local authorities
- the current statutory framework in England and Wales (Part IV of the LGHA 1989) requires authorities to set certain limits in relation to treasury management; the Prudential Code will only come into force when the old system ends whereas the TM Code is current
- there will be a requirement to explain the content of the Prudential Code to Parliament, since Parliament is being asked to place reliance on the Code
- Graham Fletcher reported that the ODPM will consider the status of both the Prudential Code and the TM Code within the developing statutory framework.

Whilst recognising that there is a minority view that the Prudential Code should only contain a cross reference to the TM Code, the PCSG decided to recommend to the Treasury Management Panel that the Prudential Code should continue to contain the current cross reference to the TM Code and in addition the prudential indicators for treasury management. This decision is linked to the consideration of the detailed format of the prudential indicators for treasury management (paragraphs 22 – 27 below). The current draft includes these indicators and this matter will be considered by the Treasury Management Panel at their meeting on 18 October.

22 The PCSG endorsed the areas for prudential indicators for treasury management as being

- variable rate interest exposures
- fixed rate interest exposures
- maturity of borrowings
- investment of principal sums.

23 In relation to interest rate exposures, it was agreed that both upper and lower limits are required for both variable and fixed interest exposures. However, it was agreed that more of the detail form should be left to the individual local authority to decide

rather than being prescribed, including whether to have just two sets of indicator for fixed and for variable or to have more subdivisions, and whether to express the limits in terms of absolute amounts or percentages.

- 24 In relation to the maturity of borrowings, it was agreed to require as a minimum limits to be set for the following time periods:
- under 12 months
  - 12 and under 24 months
  - 24 months and under 5 years
  - 5 years +.
- 25 It was agreed that prudential indicators in respect of the investment of principal sums for greater than a year should be retained.
- 26 These changes have been made to the format of the prudential indicators for treasury management in the revised draft. The changes made have resulted in far fewer treasury management indicators, although it is recognised that some commentators would prefer fewer still. A balance needs to be struck in respect of both practicality and robustness. These are key areas of risk on which assurance is necessary. The local authorities who are road testing the Code have been asked to use and comment on these revised treasury management indicators.
- 27 At the first set of workshops for local authorities who are roadtesting the draft Code, comment was made by participants that there was no reference in the 2001 consultation draft to roundtripping. It is suggested that it would be appropriate to add a paragraph on this topic and proposed text has been included at paragraph 33 in the current draft.

#### MATTERS TO BE TAKEN INTO ACCOUNT – AFFORDABILITY

- 28 At the last meeting of the PCSG it was agreed that consideration be given to having a separate section on affordability as an aide to greater clarity.
- 29 In order to progress this, the current draft suggests moving the prudential indicator for the ratio of revenue cost to net revenue stream to the part of the Code that deals with matters to be taken into account – affordability.
- 30 Also, a new indicator is suggested here with respect to the impact on the Council Tax.
- 31 With respect to the ratio of financing costs to net revenue stream:
- (a) The separate indicator for the HRA has been removed within the current draft, pending overall consideration of the Code vis-à-vis the HRA (see paragraphs 63 – 67 below).

- (b) It has been pointed out through roadtesting that the element of financing costs that are for transferred debt should be subtracted from the “lead” authority and added to the appropriate authority. In the 2001 consultation draft, the local authorities concerned would be required to take this into account when considering matters of affordability. However, the prudential indicator in the 2001 consultation draft for ratio of financing costs to net revenue stream did not address this and therefore would not accurately reflect the affordability of the financing costs at the authorities concerned. The current draft implements this via amendments within the definitions section of the Code.

#### MATTERS TO BE TAKEN INTO ACCOUNT — PRUDENCE

- 32 The 2001 consultation draft already included a cross reference between this section and the prudential indicators for external debt.
- 33 In order to assist clarity, paragraph 42 of the consultation draft (now paragraph 48) has been identified as a key indicator of prudence. It has been given the short title ‘net borrowing and the capital financing requirement’.

#### PROCESS AND GOVERNANCE ISSUES

- 34 The section headed ‘process issues’ has been retitled ‘process and governance issues’, which better reflects its content.
- 35 Points of clarification have been added to the paragraphs on setting and revising prudential indicators.
- 36 A question was raised at one of the first workshops for authorities that are roadtesting the draft Code as to whether, within the limits for external debt, movements between borrowing and other long term liabilities should be at the discretion of the Chief Finance Officer, provided that the overall limits are not breached. This flexibility would be consistent with treating financing options on an equal footing and a new paragraph has been inserted in the current draft for consideration that would give effect to this.
- 37 In their response to the 2001 consultation draft, a particular issue was raised by the GLA and its functional bodies. Their response reported that in accordance with the GLA Act the Mayor of London approves the budget requirement for the GLA and its functional bodies (the London Assembly can make amendments with a two thirds majority), and asked whether the GLA should set the prudential indicators for the entire GLA group or whether the GLA and each functional body should set its own indicators. A separate meeting has been held by the Secretary with representatives from the GLA and functional bodies, who are considering the matter further. In essence, the intention of the current draft is to require the setting of the prudential indicators within the GLA and its functional bodies to follow the same route as the setting of its budget.

- 38 The PCSG is asked to consider a further issue with respect to due process and the authorised limit in paragraphs 39-43 below.
- 39 The authorised limit proposed within the current draft is an absolute limit. The authorised limit encompasses borrowing for any purpose and both short and long term borrowing. It is important in all circumstances to ensure the liquidity of local authorities. Therefore, there will need to be within the prudential framework a clear and established procedure for the circumstances where an authority is in danger of, or does, breach its authorised limit. The procedures and processes required by the Code will mean that such a circumstance is unlikely to arise, but this does not obviate the need to be able to deal in an orderly fashion with such an event.
- 40 It is expected that legislation will protect the position of lenders to local authorities. For example, the draft Local Government Bill published by ODPM includes the following clause:
- “A person lending money to a local authority shall not be bound to enquire whether the authority has power to borrow the money and shall not be prejudiced by the absence of any such power.”
- 41 With respect to local authorities, paragraph 60 of the current draft of the Code states:
- “in respect of the prudential indicators for the authorised limit on external debt, where the Chief Finance Officer forms the view that a limit is likely to be breached a report to the decision making body is required. It will then be for the decision making body to determine if it would be prudent to raise the current limit or, alternatively, to instigate procedures to ensure that the current limit is not breached. It would be good practice for the Chief Finance Officer to establish an early warning system to the executive of any problems before they become severe.”
- 42 It is suggested that this goes a considerable way towards addressing this issue for local authorities. However, it would not cover the situation where the limit is in immediate danger of being breached.
- 43 The PCSG is asked to consider whether, in addition, provision should be made within the Prudential Code for the Chief Finance Officer to be able to increase the authorised limit of the local authority on an emergency basis for a temporary period, say two weeks where this situation occurs .
- 44 With respect to monitoring arrangements some comments were received to the 2001 consultation requesting further guidance on where the Chief Finance Officer should take monitoring reports. However, at its earlier meetings the PCSG was of the view that this should be for local decision making and the responsibility of the Chief Finance Officer. Therefore, no changes have been made to the current draft in this respect and an additional sentence has been added to make the point clearer.

45 The joint response by the then DTLR and HM Treasury to the 2001 consultation draft includes the following:

“The financing cost/revenue stream should be recognised as the key in-year indicator of changes in affordability. We would wish to see its role brought out more explicitly within the Code, along with requirements for regular in-year monitoring of it and a specific review before major commitments were irrevocably entered into.”

Amendments are included within the current draft accordingly.

#### DEFINITIONS — CAPITAL FINANCING REQUIREMENT

46 Following discussion of paper PCSG 6 02/03 on the treatment of other long term liabilities at their meeting in July, the PCSG agreed that it would be preferable for other long term liabilities to be treated in accordance with UK GAAP from the start of the new system. They would then not be passed into the calculations for the amount referred to in the 2001 consultation draft as ‘capital expenditure unfinanced’ and referred to in the current redraft as ‘capital financing requirement’.

47 However, further work undertaken since July has shown that this issue is intrinsically connected with the issue of the application of depreciation within local authority accounts.

48 Therefore, instead of attempting to move forward on other long term liabilities independently of depreciation on assets financed from traditional procurement, it is recommended that the two are taken together.

49 This would mean that the calculation for the capital financing requirement will continue to capture all capital expenditure, whatever its means of financing.

50 Therefore, the definition used within the current draft for capital financing requirement remains unchanged from that used within the 2001 consultation draft for capital expenditure unfinanced.

51 Comments made on the 2001 consultation draft and during roadtesting mean that the definition used within the current draft may need to be amended slightly in order to ensure that all the intended amounts are included within it, for example loans to housing associations. Work is continuing with roadtesting authorities on this point and it is likely that a slightly amended calculation for capital financing requirement will be brought to the next meeting of the PCSG in consequence.

52 At their July meeting, the PCSG also considered the treatment of premiums on the early repayment of debt. It was agreed that, depending on the individual authority’s cash and investment position, a local authority that is carrying premiums as a prepayment on its balance sheet may not be able to comply with paragraph 42 of the

2001 consultation draft (paragraph 48 of the current draft) where the prepayment is “backed” by external borrowing over several years. It was the view of the Steering Group that the detailed wording of the current requirement should be reconsidered such that authorities in this position are recorded as complying with this requirement.

53 The payment of premiums does not constitute capital expenditure. However, any premiums that appear on the balance sheets of local authorities are present in line with current proper practice as prepayments, to be written off over time. One way of giving effect to the Steering Group’s comments on premiums would be to add prepayments for premiums to the calculation for the capital financing requirement when the amended calculation is brought before the next meeting of the PCSG. The PCSG is asked to consider this matter.

54 Further work may be necessary on the definition of the capital financing requirement in the light of preparatory developments for secondary legislation. The work requested by Martin Easton as the July meeting of the PCSG (minute 8.3 refers) has been deferred pending these further developments.

#### GREATER CLARITY WITHIN THE CURRENT DRAFT

55 The PCSG identified the need for greater clarity when the consultation draft of the Code was revised. The action points in this regard are listed in paragraphs 56 – 62 of this paper, together with the action taken to date.

56 **Action point (a):**

Reconsider the practice of having a generic term (currently prudential indicator) to cover the limits authorities are required to set, the estimates they are required to make and actual outcomes. This has caused confusion; on the other hand it is useful to have one generic term to refer to, eg for the decision making process.

**Action taken:**

The generic term ‘prudential indicator’ has been retained within the current draft because it is useful to have one generic term to refer to within the Code. The PCSG is asked to consider whether the other changes made, particularly action point (b) below, clarify the position.

57 **Action point (b):**

A review of the terminology used for each required figure, so that there is a short, ‘snappy’ descriptive name for each figure required by the Code.

**Action taken:**

This has been actioned within the current draft.

58 **Action point (c):**

A reduction in the number of prudential indicators may be possible as further work is undertaken on the Code.

**Action taken:**

The number of prudential indicators for treasury management has been considerably reduced following the decisions of the PCSG in July on the detailed format of these indicators. Further consideration is being given as to whether these prudential indicators should be a part of the Prudential Code or the Treasury Management Code.

However, two new prudential indicators are proposed within the current draft, for actual capital expenditure and for estimates of impact of financing costs on the Council Tax.

59 **Action point (d):**

An executive summary that would form part of the Code and/or explanatory notes that would not form part of the Code itself.

**Action taken:**

It is suggested that both of these should be actioned and drafts brought to the December meeting of the PCSG.

60 **Action point (e):**

The inclusion of more explanatory detail within the main text of the Code.

**Action taken:**

Amendments have been made within the current draft and the PCSG is asked to consider whether the revised text strikes the right balance on this.

61 **Action point (f):**

It would be helpful if the prudential indicators in relation to capital expenditure and commitments are placed before the prudential indicators for external debt.

**Action taken:**

The current draft has been restructured in this way.

62 **Action point (g):**

Consideration be given for having a separate section on affordability.

**Action taken:**

The current draft includes a section on affordability and prudential indicators for affordability.

THE PRUDENTIAL CODE AND THE HRA

63 It has been indicated that in England and Wales the prudential framework will apply to the HRA but the details of this for the statutory framework of the HRA have not yet been decided.

- 64 It has been indicated that in Scotland the prudential framework will not apply to the HRA.
- 65 At their July meeting, the PCSG agreed that there is still a need to await further decisions on the statutory framework before they proceed further on this issue.
- 66 It may be necessary to have separate provisions within the Prudential Code for the HRA in England and Wales, and in Scotland.
- 67 In order to prepare the second exposure draft of the Prudential Code, it would be extremely helpful to know:
- (a) Whether it will be necessary to separate HRA and non-HRA debt. If so, then a method for local authorities to determine this on a notional and defined basis will be necessary through a means external to the Prudential Code.
  - (b) Whether, alternatively, the means of separating HRA and non-HRA items for the purposes of the prudential framework will be undertaken through distinguishing between HRA and non-HRA capital expenditure and the capital financing requirement. If so, then a defined basis for calculating the HRA capital financing requirement would be required.

#### THE PRUDENTIAL CODE AND OTHER RINGFENCED ACCOUNTS

- 68 Ring fenced accounts other than the HRA typically require either that all income received is used for specified purposes and/or that they are self financing. Examples are:
- on street parking (Parking on Highways for Payment)
  - building control
  - cost recovery for traffic safety cameras.
- 69 The demonstration of the correct operation of ring fenced accounts is critically dependent on the local authority identifying the income and expenditure pertinent to the account in question. This is achieved by the local authority complying with the local authority accounting SORP and *Best Value Accounting Code of Practice* (BVACOP). The definition of total cost within BVACOP is particularly pertinent. The definition of gross total cost of services includes capital charges. The operation of the SORP and BVACOP results in accounts that demonstrate compliance (or, if this is the case, identify non-compliance) with the requirements of ring fencing.
- 70 It is suggested, therefore, that this means that there are no special requirements for the Prudential Code in relation to ring fenced accounts other than the HRA.

THE PRUDENTIAL CODE AND THE TREATMENT OF RELATED ENTITIES  
(LOCAL AUTHORITY COMPANIES, TRUSTS, LIMITED LIABILITY  
PARTNERSHIPS, ETC)

- 71 The CIPFA/LASAAC Joint Committee is undertaking work on the consideration of group accounts in local authorities. The Joint Committee's work programme is such that the earliest date for its consultation on group accounts is September 2003.
- 72 The outcome of the Joint Committee's work will need to be incorporated within the Prudential Code in due course. However, it is suggested that the implementation of the prudential framework need not await the completion of this work.
- 73 The current SORP requires the preparation of summarised group accounts as supplementary information to the main accounts, where this is appropriate. Such accounts are currently prepared by few local authorities but the amounts involved can be material.

THE PRUDENTIAL CODE AND FRS 17

- 74 Following discussion of paper PCSG 12 02/03 at their July meeting, the Steering Group agreed that affordability issues are unchanged as a result of FRS 17. It was also agreed that retirement benefits should be specifically identified in the items listed in paragraph 37 of the 2001 consultation draft (now paragraph 38) "Matters which are relevant to a consideration of affordability include:". This has been actioned within the current draft.
- 75 It was agreed at the July meeting of the PCSG to defer consideration of the treatment of assets and liabilities on the balance sheet as a result of the introduction of FRS 17 until CIPFA/LASAAC has further considered this issue in the light of the recent ASB announcement to delay full implementation of FRS 17, whilst continuing to allow for early adoption. The CIPFA/LASAAC Joint Committee considered this in September and an oral update on this will be given to the PCSG meeting.
- 76 With respect of any liabilities on the balance sheet for discretionary unfunded liabilities, the PCSG considered that if FRS 17 is adopted in full, these should be treated in the Prudential Code in the same manner as all assets and liabilities identified on the balance sheet for retirement benefits. They will continue to need to be separately identified in terms of affordability.