



REPORT

Committee	PRUDENTIAL CODE STEERING GROUP		
Venue	Thistle Hotel, Charing Cross	Date	11 July 2002
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Subject	Issues paper – draft prudential indicators for three levels of debt		

PURPOSE

To consider issues paper on draft prudential indicators for three levels of debt for consideration for revisions to the draft Prudential Code.

REPORT

1 The issue

The draft Prudential Code requires three levels of prudential indicators for debt:

- prudential limit
- authorised limit
- estimates of maxima.

Matters arising:

- (a) 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 exposure draft of the Code.
- (b) 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.
- (c) Furthermore, it was evident at the first set of roadtesting workshops that there is confusion as to what is meant by the different levels proposed in the draft without further explanation.

2 Ideas for Consideration

- (a) Within the draft Code, estimates of maxima are intended to be based on the local authority's estimates of most likely, prudent but not worst case scenarios. Thus they link directly to the Authority's plans (and prudential indicators) for both capital expenditure and for capital expenditure unfinanced; also to their estimates of cashflow requirements for the year, including for temporary revenue purposes.
- (b) The draft Code also requires that the CFO establishes procedures to monitor actual performance against the estimates of maxima, stating:

“It will probably not be significant if these estimates are breached temporarily on occasions due to variations in cashflow. However, a sustained or regular trend above the estimated maxima would be significant and should lead to further investigation and action as appropriate.”

Thus, the estimates of maxima are seen in the draft Code as a key management tool for in-year monitoring. A topical football analogy can be made with the “yellow card” estimates of maxima compared with the “red card” limit for debt.

- (c) Within the draft Code, the authorised limit for debt is a limit – ie once the Authority has set its own authorised limit, it is required not to breach it. The limit must, therefore, be set so as to allow for unusual temporary cashflow positions. The Authority will need to be sure that it is prudent for it to reach this limit on occasion – but not on a regular basis because the estimate of maxima is the main management control.
- (d) In addition to being useful for internal management control, CIPFA has suggested that the estimates of maxima are more relevant for macro economic estimates than the authorised limit. This is because if the limits set by all local authorities for a particular year are added together, the total will inevitably exceed, by a significantly large amount, the likely maxima for external debt for local authorities at any point in the timeframe concerned.
- (e) In summary, it is suggested that estimates of maxima are useful for internal management control and macro economic planning. However, they cannot operate as absolute limits because they are estimates. Conversely, if they are required to operate as limits, then they will have to be set too high to be meaningful for the first two purposes.
- (f) This is the rationale for having estimates of maxima and authorised limits.

- (g) Both estimates of maxima and authorised limits would be based on the Authority's plans. The Authority would need to assure itself that these are prudent and affordable. The estimates of maxima would be based on the most likely scenario. The authorised limits would in addition need to provide sufficient headroom over and above these for unusual cash movements.
- (h) In the draft Code, the third level of the prudential limit can 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 the limit that it could, given its economic circumstances, prudently set.
- (i) One reason for this was felt to be debt free authorities, or those with a low level of debt compared to resources, who may not wish to borrow all that they can prudently afford to do.
- (j) At the first set of roadtesting workshops, participants did not consider that having a theoretical level over and above those directly associated with the Authority's plans was meaningful or added value.
- (k) It has also been suggested that having a third level of indicator in relation to debt builds in a contingency to address risk. This is further discussed in Paper No PCSG 8 02/03.

RECOMMENDATION

The PCSG is asked to consider this issues paper on draft prudential indicators for three levels of debt for consideration for revisions to the draft Prudential Code.