CONSULTATION RESPONSE

CIPFA Prudential Code and Treasury Management Code - November 2021

Arlingclose advises 153 UK local authorities on treasury management and capital finance issues, and we are pleased to respond to the latest consultations on the Prudential Code and Treasury Management Code published on 21st September 2021.

Overview

We support the broad direction adopted by the new codes and many of the proposed changes are sensible. CIPFA has articulated the approach that a well-managed, low-risk local authority would take and recommends that everyone follows suit. But if local authorities follow the new codes and accompanying guidance dogmatically, they risk being forced down a narrow approach to borrowing and investment decision making.

We especially note that:

- the liability benchmark is a projection of the amount of loan debt which the authority needs to fund its future cash flows;
- commercial investments are defined as those taken voluntarily rather than for cash flow or risk management needs, which may include long-term deposits, bonds and pooled funds;
- local authorities must not borrow to make commercial investments.

The logical combined effect of these is that local authorities must not borrow above the liability benchmark. It therefore appears that the draft codes treating the liability benchmark as both the minimum sensible level of borrowing (any less and you run the risk of running out of cash) and the maximum permitted level (any more and you are borrowing to invest).

We understand from informal discussions that this was not the panel's intention when drafting the new codes. We suggest that the definition of a commercial investment is amended to only apply to items that are capital expenditure. The Prudential Code retains the requirement that gross debt should not exceed the CFR except for defined risk management reasons, and this will act as a natural limit on the balance of treasury management investments that can be held. Only by making capital expenditure investments can you artificially increase your borrowing beyond the level required to meet service needs.

We have also heard that much of the new codes are presented on a "comply or explain" basis. But that differs from recent statements by CIPFA that following the Prudential Code (rather than having regard to it) should be mandated by law. We strongly believe that the new codes should be very clear on which sections authorities are expected to follow absolutely, those which are recommended but can be departed from if an explanation why is provided and those that just describe best practice in an ideal world.

Prudential Code

Question 1: Do you have any comments or observations on the amendments to the code relating to new Objective for proportionate commercial investments?

At first glance, ensuring that "plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services" is a sensible objective. But since almost all commercial investments will be capital expenditure, falls in value will not impact upon budgets or usable reserves. We also note that (a) under the proposed definitions it will not be permitted to make new commercial investments in future (these are either funded from existing cash and therefore treasury investments or from borrowing and therefore banned) and (b) there is no requirement to sell existing commercial investments. This well-meaning objective may therefore be of little use unless the investment category definitions are changed.

Question 2: Do you have any comments or observations on the amendments to the code relating to the inclusion the legal status of the Code in Chapter 3?

We are content for the code's legal status to be incorporated, providing this is done correctly. However, the proposed wording is misleading – local authorities in England, Northern Ireland and Wales are only required to have regard to the Prudential Code when setting their affordable borrowing limits. It is the TM Code to which they are more generally required to have regard. We accept that compliance with some other sections is related to setting the authorised limit, and this section of the Code should expand on that.

Local authorities in Scotland "must have regard to generally recognised codes of practice and guidance in relation to capital finance and treasury management" which would include the Prudential Code.

It would be enormously helpful if chapter 3 of the Code explicitly stated which of its sections authorities are expected to follow absolutely, those which are recommended but can be departed from if an explanation why is provided, and those that just describe best practice in an ideal world.

Question 3: Do you have any comments or observations on the amendments to the code relating to the reference to environmental sustainability in contents of Capital Strategy?

It may well be true that environmental sustainability is a strategic priority and policy of many local authorities, but we see no reason for a financial code of practice to steer local authorities down this route. CIPFA will be extending its remit too far with this suggestion, unless the code can express a link between environmental issues and financial sustainability.

Question 4: Do you have any comments or observations on the amendments to the code relating to Capital Strategy's requirement to summarise investments into treasury management, service and commercial purposes?

We have no objection where local authorities have substantial service and commercial investments. But the majority of local authorities have none or very little of these, so in most cases it will not impart any useful information to the reader of the report

Question 5: Do you have any comments or observations on the amendments to the code relating to the greater clarity on commercial and service investments in the Capital Strategy, including limits, and compliance with requirement not to borrow to invest for return?

We believe that including these in the capital strategy report goes against the original idea of it being a high-level summary of capital and treasury matters, with the detail being reported elsewhere. Such matters should be reported in the investment strategy instead, following the requirements of the relevant statutory investment guidance.

The capital strategy should already note that the authority has regard to the Prudential Code, and list any departures. We see no reason why compliance with paragraph 51 should be particularly noted over the code's other requirements.

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Question 6: Do you have any comments or observations on the amendments to the code relating to the explicit requirement to set and monitor the treasury management prudential indicators in the TM Code LA Guidance?

It is not obvious to us why this requirement should be added to the Prudential Code as well as the TM Code, but we have no objection to it.

Question 7: Do you have any comments or observations on the amendments to the code relating to the quarterly monitoring of prudential indicators as part of normal budget monitoring reports?

Integrating the indicators into budget planning and monitoring, and reporting on them quarterly is already best practice and we have no issue with formalising this approach in the code. Budget planning for 2022/23 will however be mostly complete when the code is finally published.

Question 8: Do you have any comments or observations on the amendments to the code relating to the revision of 'Paragraph 45'?

The revised wording on borrowing for commercial investment is an improvement on the previous concept of borrowing more than or in advance of need, given the unclear definition of need. However, please see our comments on the definition of a commercial investment; if these are defined to include what are currently treasury management investments, then authorities will have trouble demonstrating compliance with this.

The list of four acceptable reasons to borrow is too restrictive in our view. Authorities should be permitted to refinance current borrowing to save costs, not only to reduce risk. And authorities that have issued a section 114 notice because they have an unbalanced budget should still be permitted to borrow for temporary cash flow management.

Question 9: Do you have any comments or observations on the amendments to the code relating to authorities with commercial financial investments who expect to borrow: annual strategy to review options for exiting commercial investments?

We agree that local authorities who are short of cash should evaluate the costs and benefits of selling investments as an alternative to borrowing. Similarly, authorities with surplus cash should evaluate the cost of repaying loans as an alternative to making new investments. Both are a normal part of treasury management decision making, and need not be restricted to financial investments held for commercial purposes, of which there may be few. But some of the language used, e.g. not being required to sell "immediately", implies a requirement to sell at some point. The code should clarify that authorities are not required to sell within any timeframe.

Question 10: Do you have any comments or observations on the amendments to the code relating to the new prudential indicator for net income from commercial and service investments as % of net revenue stream?

It is unfortunate that CIPFA has chosen a very similar indicator to MHCLG but with a slightly different denominator – MHCLG uses net service expenditure instead. It will likely be confusing for elected members in England to receive two sets of almost but not quite identical indicators, and we suggest this indicator could be removed from the code.

If the indicator is to be retained, we note that commercial and service investment income funds expenditure, so an expenditure denominator, or a total income denominator would make more sense than dividing one type of income by another type.

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Many authorities will of course have a nil or very small number; maybe authorities with a ratio below say 1% could be exempt from reporting this indicator.

Question 11: Do you have any comments or observations on the amendments to the code relating to the Investment Prudential Indicators to be reported together with investment indicators under Statutory Investment Guidance?

There are no investment indicators in the statutory investment guidance for Northern Ireland, Scotland and Wales, so authorities in those jurisdictions will be bemused by this requirement. And in England, authorities generally report the prudential indicators in the capital strategy and the investment indicators in the investment strategy, which seems sensible to us. Therefore, we would remove this recommendation from the code.

Question 12: Do you have any comments or observations on the amendments to the code relating to inclusion of Heritage Assets in definition of CFR?

We agree that heritage assets are capital items and should therefore be included in the calculation of the CFR.

Question 13: Do you have any comments or observations on the amendments to the code relating to the new definition of Commercial Property?

This definition is consistent with property that counts as an investment within the TM Code, and we welcome the new consistency across the two codes. But it differs from the definition of investment property in the CIPFA/LASAAC accounting code and in the various statutory investment guidance – this is unhelpful but maybe beyond CIPFA's control.

Question 14: Do you have any comments or observations on the amendments to the code relating to the removal of the deduction for interest and investment income from definition of Financing Costs?

This change is consistent with the move to control gross debt rather than net debt in recent editions of the code, and we therefore welcome it.

Question 15: Do you have any comments or observations on the amendments to the code relating to the revised definition of Investments (to include non-financial assets held primarily for financial return)?

This appears consistent with definition already adopted in the TM Code, which is welcome.

Question 16: Do you have any comments or observations on the amendments to the code relating to the clarification that Net Revenue Stream excludes capital grants and other items?

We welcome this clarification also. However, the placing of the sentence could be construed as applying to estimates only and not the actual revenue stream in the out-turn indicator. Some rewording is therefore required.

Question 17: Please detail any other comments on amendments to the code or further observations.

Our other comments are referenced according to the paragraph numbers in the consultation draft:

Foreword: We are uncomfortable with a statutory code of practice applying with immediate effect on the date of publication, before local authorities have had time to read and digest the new rules. The consultation is obviously giving a flavour of the planned changes, but there will hopefully be many changes in the final version. And given that the final code is not planned to be published until December, the

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exemption for not updating prudential indicators until the 2022/23 budget process is meaningless – this will be mostly complete by the publication date.

1(d): It is not clear what capital expenditure plans and investment plans should be proportionate to.

7: Why should local authorities not in England integrate guidance which only applies to English authorities into their decision making? In any case, the description of the MHCLG guidance may quickly be out of date as we understand it is under review. Local authorities are already obliged by law to have regard to the relevant statutory investment guidance, so there is no need for the Prudential Code to recommend this.

8 and E7: It would be helpful to clarify that the Prudential Code does not apply to parish, town or community councils, as this paragraph could be read otherwise.

24 and 52: The requirement that "authorities with restricted or no access to PWLB should note the liquidity risks this may create and where they would access borrowing from, if required" ignores the fact that local authorities in Northern Ireland do not have access to the PWLB but this does not create liquidity risks.

49: This does not correctly describe the legal powers to borrow in Scotland, which are more restrictive than those in the rest of the UK.

78: The recommendation that housing authorities should also show the proportion of financing costs to net revenue stream for the HRA brings back an indicator from previous Codes. But using the definition in paragraph 96, the HRA will have a net revenue stream of zero, and hence the "proportion" or ratio will be infinite.

93: Service loans are usually held on the balance sheet as debtors rather than investments, and therefore these will be excluded from the definition of investments. We do not believe this is the intention.

93: Cash on the balance sheet will include operational bank accounts not under the control of central finance (including schools), cash in hand, cash in transit, uncleared cheques and bank overdrafts. We believe these should be excluded from the definition of investments.

93: The phrase "including impairments" is ambiguous – does it mean with the impairment charge deducted or added back?

94: "General Fund charges for loan principal" are no longer relevant to Northern Ireland, as it adopted minimum revenue provision in 2012.

95: The definition of TM investments and commercial investments overlap: the final bullet under TM says that directly held property can be a TM investment if an explicit link to cash flow management can be demonstrated, but the definition of commercial investments includes all commercial property.

95: As mentioned in our opening remarks, we are highly uncomfortable with the idea that investments traditionally considered as treasury management tools such as high quality bonds and pooled funds should be classified as commercial investments in certain circumstances. We would limit the definition of a commercial investment to those that are capital expenditure; the ban on borrowing above the CFR would then continue, as it does now, to place a natural limit on the sum of treasury management investments.

97: Credit arrangements are also defined by legislation in Scotland: Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016, regulation 1(2).

97: As written, it is unclear whether the short-term element of PFI and lease liabilities are included or excluded from the definition – i.e. does the phrase after "or" form part of the main definition or part of the

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“other than” phrase. They believe they should be included as per the legislative definition of a credit arrangement.

97: We do not understand why there is a long list of reserves to be excluded from “other long-term liabilities” – reserves are clearly not liabilities. The reader would be better informed if long-term liabilities such as the pension liability, donated asset account and grants received in advance were listed instead. On a similar note, we would recommend this category is renamed “other debt liabilities” as it clearly does not include all other long-term liabilities and (subject to the clarification above) includes some short-term liabilities.

Treasury Management Code

Our responses below focus on the implications for local authorities rather than other public bodies to which the TM Code applies.

Question 1: Do you have any comments or observations on the amendments to the code relating to Investment Management Practices and other recommendations relating to non-treasury investments in Section 8 are required under the Clauses to be formally adopted?

This is a sensible addition.

Question 2: Do you have any comments or observations on the amendments to the code relating to the definition of treasury management being amended to explicitly include borrowing?

This usefully tidies up the definition after investments were added in 2017 and corrects an inconsistency with the introduction to the code.

Question 3: Do you have any comments or observations on the amendments to the code relating to TMP1 (1) on counterparty credit risk: counterparty policy to set out the organisation’s policy and practices relating to environmental, social and governance (ESG) investment considerations?

ESG measures of investment counterparties are not yet fully developed, and we expect local authorities will have trouble some implementing meaningful ESG counterparty criteria at this time.

The published draft includes this in the paragraph on counterparties for borrowing, not investments, and so should be moved if it is to be retained.

Question 4: Do you have any comments or observations on the amendments to the code relating to TMP 1 treasury risks have been renamed to align with general practice?

Since TMP 1[1] deals with both investment and borrowing counterparties, the original name “credit and counterparty risk” was more appropriate.

Renaming TMP 1[8] to “operational risk management” is welcome.

Question 5: Do you have any comments or observations on the amendments to the code relating to TMP 10 on training requiring a knowledge and skills schedule?

We welcome the reduced requirements compared to the first consultation draft.

Question 6: Do you have any comments or observations on the amendments to the code relating to Section 8 on non-treasury (ie service and commercial) investments definitions updated in line with Prudential Code?

The idea that treasury management includes the management of investments that are not treasury management investments is nonsensical. It would be much clearer to have a "treasury management and investment code" covering all types of investments rather than the current position which expands the definition in one paragraph and then narrows it back again in the following one.

We support consistent definitions across the two Codes, but please see our concerns and recommendations in our Prudential Code response on classing traditional treasury management investments as commercial investments.

We also note the reference to "any investments which are not taken or held for treasury management purposes" which suggests investments could change category from treasury to commercial if they are no longer held for treasury purposes. If this is alluding to the review of financial investments required by paragraph 53 of the draft Prudential Code before borrowing, whereby any investments retained become commercial investments, the definitions should be explicit on this. Otherwise the reference to "or held" should be removed.

Question 7: Do you have any comments or observations on the amendments to the code relating to all reporting under the TM Code to address service and commercial investments in appropriate categories, as well as treasury ones?

We believe that reporting under the TM Code should cover TM investments and borrowing. Non-treasury investments are already covered in the capital strategy (in summary form), quarterly prudential indicators, the investment strategy required by the various statutory investment guidance, and (since they are usually capital expenditure) in the capital programme setting and monitoring. There is no need to repeat it in the TM reports as well.

Some local authorities may choose to combine their treasury strategy with their investment strategy, but the TM Code should not mandate this approach.

Question 8: Do you have any comments or observations on the amendments to the code relating to the purposes, objectives and management of each category of service and commercial investment being described?

We agree that authorities should have written policies for making non-treasury investments, and there is some merit in holding these together in the IMPs.

Question 9: Do you have any comments or observations on the amendments to the code relating to the risks of commercial investments should be proportionate to the organisation's financial capacity?

This repeats a requirement of the Prudential Code. But why does it only apply to commercial investments? We believe that the risks associated with all investments should be proportionate to an organisations ability to bear losses. Service investments are usually higher risk and often not on commercial terms, and therefore more likely to lead to losses. Price falls in service and commercial investments, which are usually capital expenditure, do not fall upon the revenue account, but price falls in treasury investments they do, and the capacity to bear any such losses in therefore more important.

Question 10: Do you have any comments or observations on the amendments to the code relating to the Investment Management Practices for non-treasury investments?

No.

Question 11: Do you have any comments or observations on the changes for the new guidance on the treasury management prudential indicators?

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Liability benchmark: We have long supported the use of a liability benchmark and Arlingclose clients will be familiar with the concept as the forecast minimum risk level of borrowing. But it has always been seen as a benchmark – i.e. a level to compare your actual borrowing to, and therefore measure the risks the authority is exposed to, rather than a target level. In our view, it should be entirely acceptable to hold, and plan to hold, a higher or lower level of debt than the benchmark if a suitably risk-adjusted cost or return can be achieved. Unfortunately, some of the two codes' wording, particularly around the definition of commercial investments suggests otherwise. Statements like "authorities should net down their borrowing and investments in order to minimize the treasury risks resulting from running debt and investment portfolios at the same time" will unduly restrict local authorities' discretion over their level of borrowing and the risks they accept.

We are unclear how CIPFA expects local authorities to calculate the most probable option call date of their LOBO loans. Prudence would dictate that these are shown to their final maturity date in a liability benchmark; any shorter date runs the risk of authorities taking longer dated loans than needed and being over-borrowed in later years in the belief that the LOBOs would have already been called.

References to MRP in calculating the liability benchmark should include loans fund repayments for local authorities in Scotland.

Maturity structure of borrowing: Conversely, when measuring refinancing risk in this indicator, LOBOs should be shown at the earliest date they can be called, as per the current code. The problem with using a calculated most likely date is that this will change constantly, and therefore authorities will either regularly breach their maturity limits or be forced to set them very wide to cover all eventualities.

The suggestion of linking the upper and lower limits to the liability benchmark makes sense, although authorities should of course be sure to take the current portfolio structure into account.

We do not like this indicator being expressed as a percentage. Exposure to refinancing risk is better measured in £ borrowed in our opinion.

Debt-free authorities with no plan to borrow should be free to exclude this indicator, rather than show a table of zeros in every budget monitoring report.

Long-term investments: If the proposed definition of commercial investments is retained, it will be odd to include some bonds and pooled funds (those held for treasury purposes) in this indicator and to exclude others (those taken or held for commercial purposes), when they present the same risk.

The need to include bond funds but exclude money market funds make sense at first glance, but in reality there is a continuum of funds available to invest in, including cash plus funds, ultra short-dated bond funds, and short duration funds. We suggest the cut off could be to only include those funds with an average duration or weighted average maturity longer than one year.

We disagree with the guidance that long-term investments as defined here should be the same as non-specified investments in the MHCLG guidance, as the definitions are quite different. In particular, the TM Code proposal would only include treasury investments, while the paragraph 21 of the MHCLG guidance is clear that non-specified definition only applies to non-treasury investments. The Welsh and Northern Irish guidance do apply non-specified to treasury investments, but here is a separate definition in Northern Ireland, and the concept of non-specified does not apply to Scotland.

Authorities with no long-term investments should be free to exclude this indicator, rather than show a table of zeros in every budget monitoring report.

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Interest rate exposures: We are bemused by the idea that there is no recommended indicator but that authorities are particularly encouraged to show the impact of a 1% increase in interest rates; this rather sounds like a recommendation.

Price risk: We believe that the existing long-term investments indicator is sufficient to measure and limit to exposure to price risk. Reporting fair values (and so past changes in price) as described in the draft guidance notes is different to using an indicator to manage the risk of price changes in future.

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