Report to the Audit & Governance Committee

Report reference:
Date of meeting: ***22nd November 2021***

Epping Forest District Council

Portfolio: **Finance, Qualis Client & Economic Development**

Subject: **Update on Prudential & Treasury Management codes**

Responsible Officer: **Andrew Small** **(01992 564278)**

Democratic Services: **Laura Kirman** **(01992 564243)**

Recommendations/Decisions Required:

(1) To note the contents of the report (including ***Appendices A and B***), which outlines imminent changes to CIPFA's Prudential and Treasury Management codes of practice.

Executive Summary:

PART 1: PRUDENTIAL CODE

1.1 The Prudential Code plays a key role in capital finance in local authorities. Local authorities determine their own programmes for capital investment that are central to the delivery of public services. The Prudential Code was developed by CIPFA as a professional code of practice to support local authorities in taking their decisions. Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003.

1.2 In financing capital expenditure, local authorities are governed by legislative frameworks including the requirement to have regard to CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes ("the Treasury Management Code").* See Part 2 of this report for a discussion on the Treasury Management Code.

1.3 The Prudential Code was last updated as recently as 2017. However, a decade of austerity in the public sector, and especially local government, has led to an increasing emphasis on commercialisation in order to increase income streams to protect – rather than cut – public services. Commercial property investments financed by cheap borrowing available to local authorities (through the PWLB) especially has seen a sharp increase; such activity has become increasingly controversial.

Revised Prudential Code: consultation on principles (February 2021)

1.4 In response to a recommendation from the Public Accounts Committee, CIPFA launched an initial (principles-based) consultation in February 2021 on proposals to strengthen the provisions within the 2017 Prudential Code (and the Treasury Management Code that complements it). The areas proposed for strengthening were as follows:

- Provisions within paragraph 45 of the Prudential Code to state clearly that borrowing for debt-for-yield investment is not permissible under the Code. While recognising that commercial activity is part of regeneration, it does not constitute the primary purpose of investment and is an unnecessary risk to public funds

- Any commercial investment undertaken should be consistent with statutory provisions, proportionate to service and revenue budgets and consistent with effective treasury management practice

- Requirements to assess the affordability of commercial activity within local authorities' capital strategies

- The addition of sustainability and ensuring that capital expenditure is consistent with a local authority's corporate objectives (such as diversity and innovation) and the objectives in the Prudential Code; and

- Introduction of new prudential indicators on affordability; External Debt to Net Service Expenditure (NSE) ratio, and Commercial Income to NSE; and

- The introduction of a "Liability Benchmark" to promote good practice and an understanding of local authority's debt management in relation to capital investment.

Revised Prudential Code: detailed consultation (September 2021)

1.5 The initial consultation closed in April 2021 with over 100 responses received from interested parties. Based on the feedback received, CIPFA launched its detailed consultation on the Prudential Code in September 2021 with firm proposals to take forward into a revised Code the following:

- 'Paragraph 45' is to be updated and revised to include the proposals for strengthening the Code in the consultation

- Inclusion of "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

- 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); and

- The introduction of the Liability Benchmark as a Treasury Management Indicator for local government bodies.

Revised Prudential Code: comment

1.6 A draft revised Prudential Code has been released by CIPFA as part of the detailed consultation and a summary is presented in ***Appendix A***.

1.7 The revised Code brings greater clarity to a range of areas. A high-profile example is commercial investments (*"it is important that the risks of commercial investments are proportionate to an authority's overall capacity i.e. that plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services and the level of resources available to the organisation"*). The revised Code also emphasises that the fundamental principles remain unchanged (e.g. security and liquidity should always take priority over yield).

1.8 It is also clear that (revised) Treasury Management Indicators will assume a higher profile than previously. The introduction of the "Liability Benchmark" as a mandatory indicator is the most significant example. It will be an indicator spanning 10 years, with CIPFA arguing that it is an essential Risk Management tool that will identify an optimum borrowing level; borrowing above that level will be reflected in increased investment balances and introduce a 'cost of carry' and additional credit risk implications (although this may be needed to anticipate interest rate movements and secure affordable borrowing).

Revised Prudential Code: the way forward

1.9 CIPFA intends to publish the revised Prudential Code in December 2021; its principles will take immediate effect, and compliance is required with effect from 2022/23.

1.10 Finance officers – with the support of Arlingclose – are now considering the detailed implications contained within the proposals and will bring forward updated Capital and Treasury Management strategies for 2022/23 for consideration by this Committee in January 2022. No major departures from the existing strategies adopted by the Council for 2021/22 are anticipated at this stage, although some refinements will be required to achieve full compliance with the revised Code.

PART 2: TREASURY MANAGEMENT CODE

2.1 As with the Prudential Code, the Treasury Management Code was last updated in 2017. However, since then the landscape for public services has changed. The increasing profile of the role of Treasury Management as a result of the pandemic, the disciplines and skills required to meet the advances brought forward by issues such as the Markets in Financial Instruments Directive ("MIFID II") and the increasing complexity of transactions in the sector all underline the importance of the Treasury Management Code and its guidance.

2.2 In addition, CIPFA argues that the rise in commercial investments is a contributing factor behind the need to strengthen its provisions to ensure that they are fit for the 21st century.

Revised Treasury Management Code: consultation

2.3 Based on feedback from its principles-based consultation launched in February 2021, CIPFA has brought forward detailed proposals for a revised Treasury Management Code (alongside proposals for a revised Prudential Code described above).

2.4 The revised Code primarily introduces strengthened requirements for skills and training, and for investments which are not specifically for Treasury Management purposes.

Revised Treasury Management Code: comment

2.5 A draft revised Treasury Management Code (including Guidance Notes) has been released by CIPFA as part of its detailed consultation.

2.6 The revised Code introduces a limited number of changes to Treasury Management Practices (TMPs), including “TMP10” which makes the requirement for appropriate expertise, knowledge and skills more explicit. The Code also includes a new section on Investments that are not part of Treasury Management activity covering “commercial investments” and “service investments” with the emphasis on the identification, categorisation and reporting of such investments with greater clarity, including the level of risk.

2.7 The Guidance Notes now include a detailed emphasis on the “Liability Benchmark” (a new Prudential Code requirement as stated above).

Revised Treasury Management Code: the way forward

2.8 CIPFA intends to publish the revised Treasury Management Code (including Guidance Notes) in December 2021; its principles will take immediate effect, and compliance is required with effect from 2022/23.

2.9 As noted above, Finance officers are now considering the detailed implications contained within the proposals and will bring forward updated Capital and Treasury Management strategies for 2022/23 for consideration by this Committee in January 2022.

2.10 The proposals included in the revised Treasury Management Code around expertise, knowledge and skills are entirely compatible with the recruitment strategy currently being rolled out in the Corporate Finance Team.

2.11 In addition, the detailed guidance on the preparation of the Liability Benchmark will assist officers in the development of the indicator.

PART 3: THE ARLINGCLOSE RESPONSE

3.1 Arlingclose – the Council’s Treasury Management advisors – have submitted a detailed response to the CIPFA consultations on both the Prudential and Treasury Management Codes. The headline message from their response is as follows:

“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”.

3.2 The Arlingclose response is presented in ***Appendix B***.

Reasons for Proposed Decision:

To update members of the Audit and Governance Committee on important developments affecting capital financing and treasury management in local government.

Legal and Governance Implications:

Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003. The statutory framework also extends to having regard to CIPFA's Treasury Management Code.

(MHCLG) Statutory Guidance on Local Government Investments (3rd Edition). Issued under section 15(1)(a) of the Local Government Act 2003 and effective for financial years commencing on or after 1st April 2018.

Safer, Cleaner and Greener (SCG) Implications:

There are no direct SCG implications contained within the report.

Consultation Undertaken:

CIPFA consultations were published on both the Prudential Code and Treasury Management Code on 1st February 2021 (principles) and 21st September 2021 (detailed).

Background Papers:

CIPFA's detailed consultations on the Prudential and Treasury Management Codes published on 21st September 2021 can be viewed via the following links.

https://www.cipfa.org/policy-and-guidance/consultations/prudential-code-for-capital-finance-in-local-authorities

https://www.cipfa.org/policy-and-guidance/consultations/treasury-management-in-the-public-services-code-of-practice-and-cross-sectoral-guidance-notes-consultation

Risk Management:

There are a range of inherent financial risks associated with Capital Financing and Treasury Management activity. The process is therefore underpinned by codes of practice that have a statutory basis.

It is also a specialist, and often complex area, so the Council engages the services of external advisors, Arlingclose Limited.

Appendix A

The revised Prudential Code 2021 (Draft Summary)

Introduction

A1) The Prudential Code plays a key role in capital finance in local authorities. Local authorities determine their own programmes for capital investment that are central to the delivery of quality public services. The Prudential Code was developed by CIPFA, the Chartered Institute of Public Finance and Accountancy, as a professional code of practice to support local authorities in taking their decisions. Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003.

A2) In financing capital expenditure, local authorities are governed by legislative frameworks including the requirement to have regard to CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

Objectives

A3) The framework established by the Prudential Code should support local strategic planning, local asset management planning and proper option appraisal. The objectives of the Prudential Code are to ensure, within a clear reporting framework, that a local authority's capital expenditure plans and investment plans are affordable and proportionate; that all external borrowing and other long-term liabilities are within prudent and sustainable levels; that the risks associated with investments for commercial purposes are proportionate to their financial capacity; and that treasury management decisions are taken in accordance with good professional practice. In exceptional cases the Prudential Code should provide a framework which will demonstrate that there is a danger of not ensuring this, so that the local authority concerned can take timely remedial action.

A4) The Prudential Code requires authorities to look at capital expenditure plans, investments, and debt in the light of overall organisational strategy and resources and ensure that decisions are being made with enough regard to the long-run financing implications and potential risks to the authority. Effective financial planning, option appraisal, risk management and governance processes are essential in achieving a prudential approach to capital expenditure, investments and debt.

A5) To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out the indicators that must be used, and the factors that must be taken account of. The Prudential Code does not include suggested indicative limits or ratios. These will be for the local authority to set itself, subject only to any controls under Section 4 of the Local Government Act 2003 (England and Wales).

A6) The prudential indicators required by the Prudential Code are designed to support and record local decision-making in a manner that is publicly accountable. They are not designed to be comparative performance indicators. They should be considered in parallel with the treasury management indicators required by the *CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

Scope

A7) The Prudential Code applies to all local authorities, including combined authorities, police and crime commissioners, fire and rescue authorities, and other authorities.

Process and Governance Issues

A8) Prudential indicators for previous years will be taken directly from information in local authorities' Statements of Accounts. If any item within a local authority's Statement of Accounts that is relied on for a prudential indicator is the subject of audit qualification, this must be highlighted when the prudential indicators are set or revised.

Matters Required to be Considered

A9) In setting or revising its prudential indicators, the local authority is required to have regard to the following matters:

- *Service Objectives* e.g. strategic planning for the authority
- *Stewardship of Assets* e.g. asset management planning
- *Value for Money* e.g. option appraisal
- *Prudence and Sustainability* e.g. risk, implications for external debt and whole life costing
- *Affordability* e.g. implications for council tax/district rates; and
- *Practicality* e.g. achievability of the forward plan.

A10) The Local Government Act 2003 refers to affordability and the requirement that local authorities in England and Wales determine and keep under review the amount of money they can afford to borrow for capital investment. In order to carry out their duties under legislation in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability, sustainability and prudence.

Decision-Making on Capital Investment

A11) A soundly formulated capital investment programme must be driven by the desire to provide high quality, value for money public services. The Prudential Code recognises that in making its capital investment decisions the authority must have explicit regard to option appraisal and risk, asset management planning, strategic planning for the authority and achievability of the forward plan.

Determining a Capital Strategy

A12) In order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a capital strategy that sets out the long-term context in which capital expenditure, borrowing and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. Authorities should report on and clearly distinguish investments for treasury management, service, and commercial purposes.

Determining a Capital Strategy

A13) The local authority shall ensure that all its capital expenditure, investments and borrowing decisions are prudent and sustainable. In doing so it will take account of its arrangements for the repayment of debt (including through MRP) and consideration of risk, and the impact, and potential impact, on the authority's overall fiscal sustainability. While indicators for prudence are required to be set over a minimum three-year rolling period, indicators should be set in line with a capital strategy and asset management plan that is sustainable over the longer term. Where statutorily ringfenced resources such as the HRA, the indicators should be set separately for these areas.

A14) Both the authorised limit and the operational boundary for external debt need to be consistent with the authority's plans for capital expenditure and financing, and with its treasury management policy, strategy and practices. Risk analysis and risk management strategies should also be taken account of. The operational boundary should be based on the authority's estimate of most likely (i.e. prudent, but not worst-case) scenario and should equate to the maximum level of external debt projected by this estimate. The authorised limit in addition needs to provide headroom over and above the operational boundary, enough for example for unusual cash movements.

A15) In order to ensure that over the medium term gross debt will only be for a capital purpose, the local authority should ensure that gross external debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.

A16) Local authorities should avoid exposing public funds to inappropriate or unquantified risk. The prime policy objective of their treasury management investment activities is the security of funds. Authorities should consider a balance between security, liquidity and yield which reflects their own risk appetite, but which prioritises security and liquidity over yield. Investments for 'commercial purposes', which are taken primarily for financial return, are likely to be higher risk, and local authorities must not borrow to invest primarily for financial return. It is therefore important that the risks of commercial investments proportionate to an authority's overall capacity i.e. that plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services and the level of resources available to the organisation. Authorities which have an expected need to borrow should review options for exiting their financial investments for commercial purposes in their annual treasury management or investment strategies.

Affordability

A17) The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the total capital investment of the authority remains within sustainable limits. In considering the affordability of its capital plans, the authority is required to consider all resources currently available to it and those estimated to be available in the future, together with the totality of its capital plans and income and expenditure forecasts.

A18) Consideration of affordability should be considered in the light of the authority's medium-term forecast and other fiscal strategies. Capital expenditure plans should be considered alongside the cost of past borrowing, maintenance requirements and planned disposals. The authority's MRP policy will have a critical impact on the overall affordability of new borrowing and for this reason it is important to look at affordability not just in the medium term but also over the life of the asset base or underlying debt.

A19) Where ringfenced resources or separate funds such as the HRA exist, affordability must be considered against those resources available to fund borrowing.

A20) When considering affordability, the authority needs to pay due regard to risk and uncertainty. Risk analysis and risk management strategies should be taken account of.