Department for
Communities and
Local Government

# Consultation on the proposed changes to the prudential framework of capital finance

## Local Authorities Investment Code

## Minimum Revenue Provision Guidance

November 2017
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

Department for Communities and Local Government
Fry Building
2 Marsham Street
London
SW1P 4DF
Telephone: 030 3444 0000

For all our latest news and updates follow us on Twitter: https://twitter.com/CommunitiesUK

November 2017

ISBN: 978-1-4098-5132-5

# Contents

# Scope of the consultation

| | |
|---|---|
| Topic of this consultation: | Consultation on the proposed changes on the prudential framework |
| Scope of this consultation: | This consultation seeks views on the proposals for updating the prudential framework |
| Geographical scope: | These proposals relate to England only. |
| Impact Assessment: | The proposed policy changes are not within the scope of the Reducing Regulation Committee and so do not need an Impact Assessment for this purpose. |

## Basic Information

| | |
|---|---|
| To: | The consultation is aimed at  local authorities and other intrested parties |
| Body/bodies responsible for the consultation: | Department for Communities and Local Governmnet |
| Duration: | This consultation will last from 10 November 2017 and will conclude on 22 December 2017. |
| Enquiries: | For any enquiries about the consultation please contact Danielle Angelopoulou at: Danielle.angelopoulou@communitites.gsi.gov.uk |
| How to respond: | To respond to this consultation, please e-mail: LA.FinancialControlFramework@communities.gsi.gov.uk<br><br>When responding, please ensure you have the words “Consultation on the proposed changes on the prudential framework” in the email subject line.<br><br>Alternatively you can write to:<br>Danielle Angelopoulou<br>Department of Communities and Local Government<br>2nd floor, SE Quarter<br>Fry Building<br>2 Marsham Street<br>LONDON<br>SW1P 4DF<br><br>When responding, please state whether you are responding as an individual or representing the views of an organisation or a local authority and include:<br>- your name, |

| | |
|---|---|
| | - your position (if applicable),<br>- the name of organisation (if applicable),<br>- an address (including post-code),<br>- an email address, and<br>- a contact telephone number |

# Introduction

1. The Department for Communities and Local Government has policy responsibility for the Prudential System. This covers the responsibility for ensuring that the statutory guidance drives local authorities to make borrowing and investment decisions in a way that is commensurate with their statutory responsibilities and the best value duty. It also includes overall responsibility for the local government finance system, including understanding the risks to the system from changes in the types of borrowing and investment activities that local authorities are undertaking.

2. The statutory framework for the Prudential System is set out in Chapter I of the Local Government Act 2003 and in the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended. The framework incorporates four statutory codes. These are:

    - The Prudential Code prepard by CIPFA
    - The Treasury Management Code prepared by CIPFA
    - The Statutory Guidance on Local Authority Investments prepared by DCLG
    - The Statutory Guidance on Minimum Revenue Provision prepared by DCLG

3. The two Codes prepared by CIPFA apply to local authorities in England, Scotland and Wales. CIPFA has run a consultation on updating those codes and will publish its response in due course. Any comments on those codes are outside the scope of this consultation and will not form part of DCLGs consideration of responses.

4. The Statutory Guidance on Local Authority Investments and the Statutory Guidance on Minimum Revenue Provision apply to local authorities in England. The Statutory Guidance on Local Authority Investments applies to all major authorities. It may also apply to parishes and other smaller authorities where their total investments exceed the financial thresholds specified in the guidance. The Statutory Guidance on Minimum Revenue Provision applies only to major authorities.[1]

[1] The definition of major authorities includes the following types of body: a County Council in England; a District Council; a London borough council, the Greater London Authority, the Council of the Isles of Scilly, a Police and Crime Commission for a police area in England, The Commissioner of Police of the Metropolis, a Fire and Rescue Authority in England, a Combined Authority, the Broads Authority and a National Park Authority for a National Park in England.

# Statutory Guidance on Local Authority Investments

5. The Statutory Guidance on Local Authority investments (“Investments Guidance”) covers proper practices that local authorities are required to follow when making investment decisions.  It gains its statutory status from Section 15(1)(a) of the Local Government Act 2003.  Under that section local authorities are required to have regard to such guidance as the Secretary of State may issue.

6. The Investments Guidance was last updated in 2010, following Parliamentary inquiries into local authority investments in Icelandic Banks.  As a result the Investments Guidance was very focused on investments in financial instititutions.

7. Over the past seven years, the economic and regulatory landscape has changed significantly.  The prolonged low interest rate environment has meant that investing spare cash in banks will not generate a return.  In addition, the introduction of the general power of competence has given local authorities far more flexibility in the types of activity they can engage in.

8. The changes in the economic and regulatory landscape have led the sector to consider different and more innovative types of investment activity.  As a result the Government feels that it is time to look into updating the guidance as part of the the more general update of the statutory codes comprising the prudential framework.

## General principles informing the update

9. The 2010 edition of the Investments Guidance only covers financial investments.  As local authorities are increasingly investing in non-financial yield bearing investments it is important to bring them within scope.

10. The Government recognises that a one size fits all approach is not appropriate given the increasing variation in the objectives and nature of local authority investment activity.  At the same time, the Government does not want to discourage local authorities from investing to deliver local economic regeneration, even if this means taking on projects that the private sector may not consider.

11. However, the Government believes that local authorities need to be better at explaining “why” not just “what” they are doing with their investment activity.  That means that the sector needs to demonstrate more transparency and openness and to make it easier for informed observers to understand how good governance and democratic accountability have been excercised.

12. At the same time local authorites need to remember that their prime duty is to deliver statutory services for local residents and they have stewardship of public funds to do so.  Given this they should ensure that the level of debt taken on and aggregate risk is

proportionate to the size of the authority and that they have considered the opportunity costs as well as the potential benefits of investment activities.

## Transparency and democratic accountability (paragraphs 12-16)

13. The revised guidance retains the requirement for an Investment Strategy to be prepared at least annually.  However, in recognition that the CIPFA consultation on the Prudential Code introduces a new requirement for local authorities to prepare a Capital Strategy, the revised guidance specifically allows the matters required to be disclosed in the Investment Strategy to be disclosed in the Capital Strategy.

***Question 1: Do you agree with the proposed change? If not why not; and what alternative would you propose?***

## Principle of Contribution (paragraph 17)

14. The core function of a local authority is to deliver statutory services to local residents. Where a local authority chooses to invest in non-core activities, management time and resource will be diverted from that core function.  Where a local authority is investing in a yield bearing investment, the contribution may be the net return that can be invested in core activities.  However, the Government is aware that investments made by local authorities may have more than one objective and as a result a local authority may have a different risk appetite to that it would have if investing solely for yield.  For this reason the Government believes that a new principle requiring local authorities to disclose the contribution that non-core investments make towards core functions is important.

***Question 2: Do you agree that it is important for local authorities to disclose the contribution that investment activities make to their core functions? If not why not; and what alternative would you propose?***

***Question 3: Are there any other measures that would increase the transparency of local authority financial and non-financial investments that you would suggest for inclusion in the Investments Guidance to assist scrutiny by the press, local taxpayers and councillors?***

## Use of indicators to assess total risk exposure (paragraphs 18-20)

15. The Government believes that it is important that Councillors or the equivalent, understand the total exposure of their local authority due to borrowing and investment decisions and that this information is presented in such a way that allows them to compare any change in exposure from year to year.

16. For this reason the Government proposes introducing a new requirement to include quantitative indicators that will allow assessment of exposure. The Government recognises that different local authorities will have different financial positions and risk appetite. For this reason the Government does not propose to specify particular indicators or thresholds.

    ***Question 4: Do you agree with the introduction of a requirement to enable Councillors to assess total exposure from borrowing and investment decisions? If not why not; and what alternative would you propose?***

    ***Question 5: Do you agree with the decision not to specify indicators or thresholds? If not why not; and what alternative would you propose?***

## Extention of principle of Security, Liquidity and Yield to non-financial investments (paragraphs 21-36)

17. The Government believes that where local authorities invest in non-financial assets, they should apply the principles of prioritising security and liquidity over yield in the same way that they are required to do for financial assets.

18. The Government recognises that the risks to security and liquidity for non-financial assets are different to those for financial assets. For this reason the Government proposes the following defintions for non-financial assets:

    - **Security:** the revised guidance recognises that a local authority will normally have an asset that can be used to recoup capital invested. Therefore, the revised guidance requires local authorities to consider whether the underlying asset is impaired and if it is, to detail the actions planned or in progress to protect the funds invested.
    - **Liquidity:** the revised guidance requires local authorities to set out the procedures for ensuring that funds invested in a non-financial asset can be accessed when they are needed.

***Question 6: Do you agree with the extention of the principles of security and liquidity to non-fnancial assets? If not why not; and what alternative would you propose?***

***Question 7: Do you agree with the definitions of liquidity and security for non-financial assets? If not why not; and what alternative would you propose?***

## Introduction of a concept of proportionality (paragraphs 37-39)

19. The Government is concerned that some local authorities may become overly dependent on commercial income as a source of revenue for delivering statutory services. Given the nature of assets that local authorities are investing in this could leave them exposed to macro-economic trends. For example a decline in retail rental yield may leave a local authority that is highly dependent on retail rental income to deliver core services with a structural funding deficit.

20. For this reason the Government proposes requiring local authorities to disclose their dependence on commercial income to deliver statutory services and the amount of borrowing that has been committed to generate that income.

***Question 8: Do you agree with the introduction of a concept of proportionality? If not why not; and what alternative would you propose?***

## Borrowing in advance of need

21. Borrowing solely to invest rather than to deliver statutory services or strategic objectives has always been considered to be borrowing in advance of need. The Government believes that it is appropriate for the revised Guidance that recognises this and requires additional disclosure by local authorities who borrow solely to invest in revenue generating investments.

***Question 9: Do you agree that local authorities who borrow solely to invest should disclose additional information? If not why not; and what alternative would you propose?***

## Capacity, skills and culture

22. The Investments Guidance has always required disclosure of the steps Treasury Management professionals have taken to ensure that they have sufficient knowledge and expertise to be able to take sensible decisions. The Government believes that it is sensible to extend this requirement to statutory officers, Councillors and other key individuals in the decision making process.

    ***Question 10: Do you agree with the extention of the disclosure requirement on steps taken to secure sufficient expertise to include all key individuals in the decision making process? If not why not; and what alternative would you propose?***

# Minimum Revenue Provision Guidance

23. The Capital Finance – Guidance on Minimum Revenue Provision ("the MRP Guidance") contains statutory guidance that local authorities are required to have regard to when calculating the annual amount of MRP to put aside. The MRP Guidance gains it statutory status from section 21(1A) of the Local Government Act 2003, which allows the Secretary of State to issue guidance "about the accounting practices to be followed by a local authority, in particular with respect to the charging of expenditure to a revenue account."

24. Local authorities are normally required each year to set aside some of their revenues as provision for debt. More precisely, the provision is in respect of capital expenditure financed by borrowing or long term credit arrangements.

25. The MRP Guidance was last updated in 2012 following the introduction of HRA self-financing. DCLG has been monitoring the practices and principles used by local authorities when deciding how much MRP to charge. In addition, in 2016, the NAO value for money report on Local Authorities Capital Investment and Financing discussed the impact that debt servicing costs could have on the financial sustainability of individual authorities and the steps being taken to manage this cost and the matter was briefly discussed at the Public Accounts Committee meeting in Parliament that considered the report.

26. Given the changes in current practice and recent interest, the Government feels that it is time to look into updating the guidance as part of the more general update of the statutory codes comprising the prudential system.

27. There are four main changes proposed from the previous guidance

## Definition of 'Prudent Provision' in the MRP Guidance (paragraphs 19-22)

28. Regulation 28 of the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* requires local authorities to make "prudent provision". The current MRP Guidance explains that "provision for the borrowing which financed the acquisition of the asset should be made over a period bearing some relation to that over which the asset continues to provide a service". The thinking behind this principle is that MRP is the cost that LAs recognise in their accounts instead of depreciation and therefore prudent provision should align to depreciation as far as is relevant.

29. Given that the purpose of MRP is to make prudent provision for debt the Government believes that this definition is slightly misleading. For this reason the Government

proposes to change the definition of prudent provision to one that requires local authorities to set MRP in a way that covers the gap between the Capital Financing Requirement and the amount of that requirement that is funded by income, grants and receipts.

30. In doing so, local authorities will be able to better align the period over which they charge MRP to one that is commensurate with the period over which their capital expenditure provides a benefit.

***Question 11: Do you agree with the change to the definition of the basis of MRP? If not why not; and what alternative would you propose?***

## Meaning of a charge to the revenue account (paragraphs 24 & 25)

31. Regulation 27 of the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* requires local authorities to make a charge to a revenue account. There have been some reports of local authorities who have determined that they have previously overpaid and as a result have made a credit to the account for MRP.

32. The Government does not believe that crediting the revenue account is either prudent or within the spirit of the approach set out in the Regulations. For this reason, the Government has included a clear statement in the updated Regulations that a charge to the account should not be a negative charge.

***Question 12: Do you agree that the Guidance should clarify that a charge to an account cannot be a credit? If not why not; and what alternative would you propose?***

## Impact of changing methods of calculating MRP (paragraphs 26 & 27)

33. The Government continues to believe in the importance of allowing local authorities to have the flexibility to change the methods that it uses to calculate MRP from time to time.

34. However, the Government has concerns that some local authorities have been changing methodologies, not because the change would better allow them to make prudent provision, but instead to reduce their annual charge and in some cases to allow them to defer payments into future years. The Government does not believe that either of these rationales for changing methodologies are prudent.

35. For this reason, the Government has decided to clarify the approach to be adopted when changing the methodologies used to calculate MRP. Under the updated code, local authorities will be allowed to offset overpayments of MRP against charges in future years. However, the revised guidance makes it clear that an overpayment cannot be calculated retrospectively.

36. For example, if a local authority calculated MRP of £15m in 2013-14 and decided to charge £20m of MRP, it would have a £5m overpayment that could be offset against charges in future years. However, if the local authority changed its methodology in 2016-17 and based on the revised calculation determined that it should have charged £12m in 2013-14, it would still have a £5m overpayment that could be offset.

***Question 13: Do you agree that changing MRP methodology does not generate an overpayment of MRP? If not why not; and what alternative would you propose?***

## Introduction of a maximum economic life of assets (paragraph 41)

37. Two of the four recommended options for calculating MRP in the Guidance use asset life as the denominator. The Government has concerns that some local authorities may be setting artificially long asset lives to reduce the annual charge for MRP and thereby deferring revenue costs into future years.

38. The Government does not believe that this is a prudent approach and for this reason the updated Guidance includes a maximum useful economic life of 50 years for freehold land and 40 years for other assets. The useful economic lives have been selected with commonly used practices in depreciation accounting in mind.

***Question 14: Do you agree that the guidance should set maximum useful economic lives for MRP calculations based on asset life? If not why not; and what alternative would you propose?***

***Question 15: Do you agree with the maximum useful economic lives selected? If not why not; and what alternative would you propose?***

## Implementation timetable

39. The Government would like both updated codes to come into force for the 2018-19 financial year.

    ***Question 16: Do you agree that the codes should be implemented in full for 2018-19? If not, are there any specific proposals where implementation should be deferred, and what would be the implications of not doing so?***

## Public Sector Equality Duty

40. We do not believe that there are any public sector equality duty implications of this proposed consultation. However, we welcome any representations respondents wish to make on this issue.

# About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department for Communities and Local Government will process your personal data in accordance with DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.
Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact us via the complaints procedure.