Part A

Report to: **Finance Scrutiny Committee**

Date of meeting: **Monday, 22 November 2021**

Report author: **Head of Finance**

Title: **Capital Finance Framework**

1.0 **Summary**

1.1 This report provides an overview of the Capital Finance Framework and an update on the proposed changes to the framework including the consultation on changes to the Prudential Code for Capital Finance in Local Government.

2.0 **Risks**

2.1

Nature of risk	**Consequence**	**Suggested Control Measures**	**Response** (treat, tolerate, terminate or transfer)	**Risk Rating** (combination of severity and likelihood)
Failure to comply with legislation and statutory guidance	Qualification of the Council's Statement of Accounts by External Audit, intervention by DLUCH or CIPFA	Officers keep up to date with the latest legislation and statutory guidance	Treat	4
Changes to legislation or statutory guidance impact on the Council's MTFS or planned capital investment	The Council is not able to access PWLB and / or effectively manage and maintain the Council's investment portfolio	'Soft' implementation of the revised Prudential Code from April 2022 with full compliance in April 2023 which will give time to assess any potential impact and take mitigating measures.	Treat	4

3.0 **Recommendations**

3.1 This paper provides an update to members regarding government policy and regulations. There are no recommendations arising directly from this report.

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Report approved by: Alison Scott, Shared Director of Finance

4.0 Detailed proposal

4.1 The Capital Finance Framework

4.1.1 The Capital Finance Framework comprises underlying legislation, which local authorities must adhere to, and statutory codes, published by the Chartered Institute of Public Finance and Accountancy (CIPFA), and guidance, issued by the Secretary of State, which they must have regard to.

Primary Legislation:
- Local Government Act 2003
- The Local Authorities Capital Finance and Accounting Regulations 2003

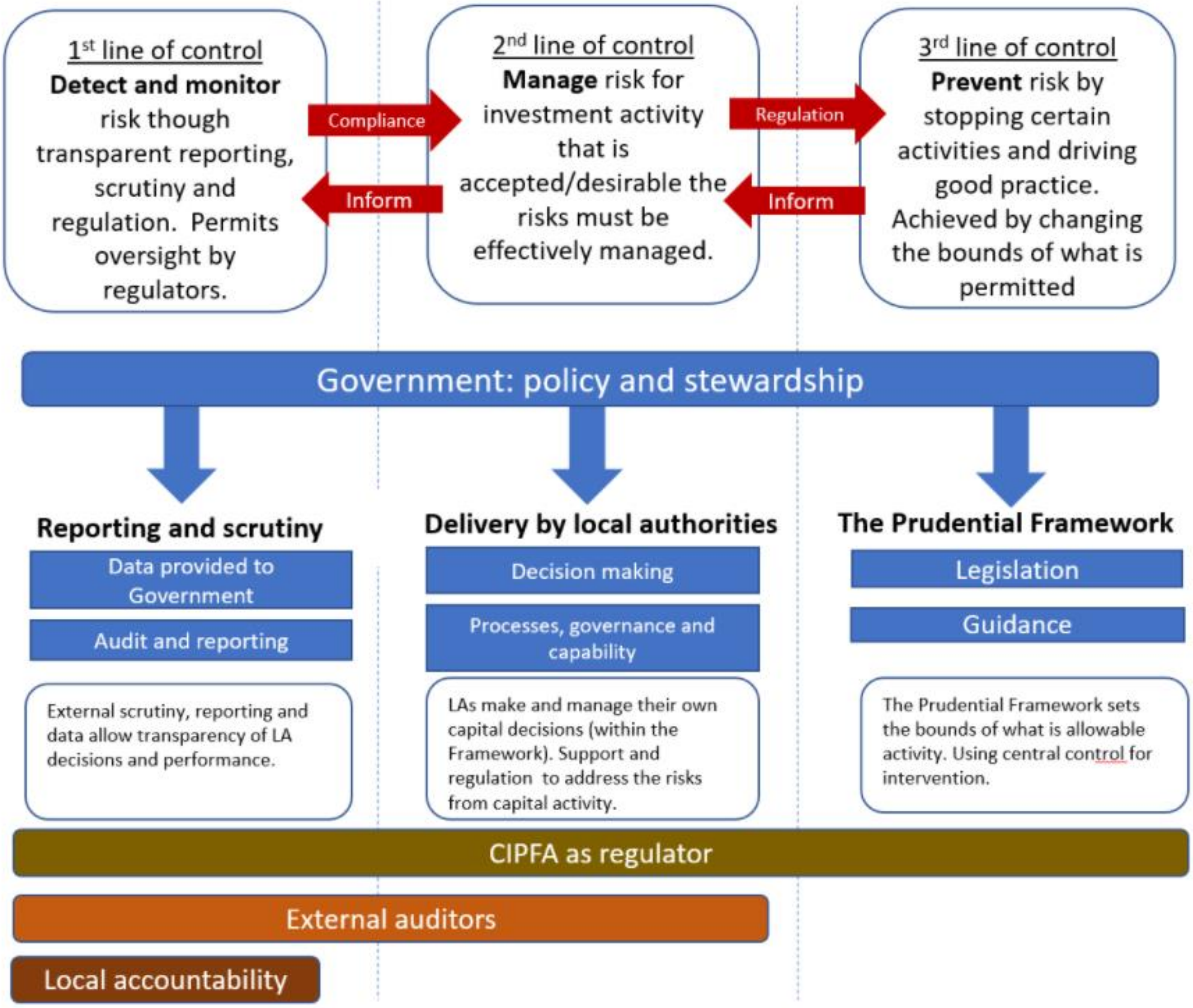
Statutory Codes and guidance:
- The Prudential Code for Capital Finance in Local Government (CIPFA)
- Treasury Management Code of Practice (CIPFA)
- Statutory Guidance on Minimum Revenue Provision
- Statutory Guidance on Local Government Investments

4.1.2 Since 2020 there have been a number of reviews and reports that have commented on the adequacy of the capital finance framework:
- MHCLG Post implementation review of changes to the local authority capital finance framework (April 2020)
- The National Audit Office (NAO) report on local authority commercial investments (February 2020)
- Public Accounts Committee (PAC) report Local authority commercial investment (July 2020)

4.1.3 The current system to regulate capital finance has been in place since 2004 and there have been piecemeal updates to the statutory codes and guidance over the 17 year period. It is based on the principle of local decision making and accountability; local authorities are free to determine their own capital strategies and decide how they deliver services on the principle that they are best placed to make the decisions needed to support their local communities.

4.1.4 In July 2021 the Ministry of Housing, Communities and Local Government (subsequently renamed the Department for Levelling Up, Housing and Communities - DLUHC) published a policy paper titled 'Local authority capital finance framework: planned improvements.'

4.1.5 The policy paper sets out planned actions to address this perceived failure through a 'lines of control' model:



4.1.6 The planned actions that underpin the model are set out in four categories:

- Improving the role of DLUCH as an effective steward of the local government capital finance system (detect and manage)

  New data collection requirements have been put in place to give DLUCH greater information about investment activity and an 'early warning system' is being developed to enable timely intervention where needed.

- Improving local practices and capability (detect and manage)

  A review of the current governance and skills landscape for investment and borrowing within local authorities will be commissioned to identify the systemic issues and good practice. This review will form the evidence base for developing targeted training and guidance.

- Putting in place appropriate tools to intervene with local authorities where necessary (manage)

  Government will consider direct measures to intervene where authorities hold too much risk or demonstrate clear non-compliance with the principles of the Framework

- Ensuring that the Capital framework is fit-for-purpose to constrain financial risk and drive sound decision making (prevent)
  - Working with CIPFA as they update the Prudential and Treasury Management Codes
  - Review local authority compliance with the revised Public Works Loans Board (PWLB) lending terms that are designed to prevent debt-for yield investments
  - Clarify the regulations and guidance relating to the Minimum Revenue Provision

4.2 **Updates to the Prudential and Treasury Management Codes of Practice**

4.2.1 CIPFA have recently consulted on proposed updates to the Prudential and Treasury Management Codes of Practice. The consultations both close on 16 November 2021 and the outcome of the consultations is not yet known.

4.2.2 The consultations include proposals to amend reporting requirements, including increasing the required frequency of reporting on prudential Indicators to members from at least twice a year to quarterly.

4.2.3 The most significant clarification within the draft revised codes is the reinforcement of existing Treasury Management guidance that requires cash to be managed as 'one pot.' This is supported by the creation of new Treasury Management prudential Indicator – the 'Liability Benchmark.' This indictor is intended to act as a 'live tool' to enable authorities to identify their new borrowing requirement and the maturities at which new borrowing should be taken to match their future debt requirement and to minimize their treasury risks.

4.3 **PWLB Reforms**

4.3.1 The PWLB lending facility is operated by the UK Debt Management Office (DMO) on behalf of HM Treasury. All local authorities have access to the facility. It is primarily used to finance borrowing for capital investment but can also be used for treasury management purposes to support short term liquidity requirements.

4.3.2 The PWLB lending terms and conditions were updated in November 2020 following a consultation process. The terms and conditions are set out in Operational Circular 163. Guidance for applicants was published alongside the revised lending terms in November 2020 and subsequently updated in August 2021 to include further clarification on specific points raised by local authorities.

4.3.3 The primary aim of the revision to the terms and conditions was to prevent the use of PWLB borrowing to finance investments made on a debt for yield basis; specifically the purchase of investment assets. Within the guidance, an 'investment asset' is defined as a balance sheet asset that:

> "would serve no direct policy purpose linked to the authority's core functions, but has been acquired primarily because it would generate an income stream for the authority, which would most often (but not exclusively) be used to support wider service spending."

4.3.4 The revised lending terms came into effect from 26 November 2020. Any capital expenditure committed from that date by a local authority must comply with the revised terms in order to continue to access PWLB borrowing, even if that expenditure is funded from other resources. If a local authority is planning to acquire investment assets in any of the following three years, the authority will be unable to borrow from the PWLB to finance any expenditure in its capital programme.

4.3.5 The most significant clarification provided in the updated guidance in August relates to active portfolio management of existing investment portfolios. The update confirmed that selling an existing investment asset to acquire an alternative investment asset would result in access to PWLB being withdrawn. This will also apply in circumstances where the initial investment was funded from other resources such as capital receipts. However, the draft Prudential Code confirms that authorities with commercial property may also invest in the repair, renewal and updating of their existing commercial properties.

4.3.6 The guidance also provides clarity on investments that would meet the criteria to be considered regeneration. As an example, this could include the purchase of a shopping centre within a local authority area but crucially the council would need to be clear about how any surplus income would be spent and ensure it is not directed towards general service spending.

4.3.7 PWLB is not the only source of borrowing available to local authorities. Local authorities can also borrow from the market or raise finance through issuing municipal bonds. However, both of these options carry different risks as they are likely to cost more and may not be available at the point that finance is needed presenting a liquidity risk.

4.4 **Clarification of regulations and guidance in relation to the Minimum Revenue Provision (MRP)**

4.4.1 Local authority debt is measured by the Capital Financing Requirement (CFR) which is essentially the cumulative difference between the authority's capital expenditure and the amount of funding that has been applied to the expenditure. Funding can take the form of a revenue contribution, capital receipt or capital grants and contributions.

4.4.2 Under the Capital Finance and Accounting Regulations 2003, local authorities must set aside MRP for the repayment of debt. This is an annual charge to the revenue account and reduces the CFR. The regulations set out the requirement that the amount of the charge is 'prudent'. The statutory guidance on MRP sets out options for calculating the charges and all local authorities are required to set an MRP policy annually.

4.4.3 When a decision is made to finance a capital investment through prudential borrowing, the prudential framework requires local authorities to consider both the cost of interest and the MRP charge when assessing whether or not the investment is affordable.

4.4.4 The NAO and PAC reports into local authority investments both highlighted concerns about consistency across the local government sector in charging MRP. The PAC explicitly recommended that MHCLG should undertake a review of the MRP guidance and consider whether its statutory basis should be strengthened.

4.4.5 A consultation is expected to be launched shortly in respect of proposed strengthening of the regulations moving forward. Until the outcome of the consultation is know it is not possible to assess the financial impact.

5.0 **Implications**

5.1 **Financial**

5.1.1 The Shared Director of Finance comments that the updated statutory framework will be applied when making future capital investment decisions. The financial implications will be considered as part of setting the Capital programme and Medium Term Financial Strategy for 2022/23 onwards.

5.2 **Legal Issues** (Monitoring Officer)

5.2.1 The Group Head of Democracy and Governance comments that the Council is required to comply with the statutory framework for local authority capital finance, including statutory guidance and the CIPFA Prudential Code for Capital Finance.

Background papers

No papers were used in the preparation of this report.