Response to the Consultation on Proposed Changes to the Prudential Framework of Capital Finance: Local Authorities Investment Code and Minimum Revenue Provision Guidance

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Submission

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About the Local Government Association

The Local Government Association (LGA) is the national voice of local government. We work with councils to support, promote and improve local government.

We are a politically-led, cross party organisation that works on behalf of councils to ensure local government has a strong, credible voice with national government. We aim to influence and set the political agenda on the issues that matter to councils so they are able to deliver local solutions to national problems. The LGA covers every part of England and Wales, supporting local government as the most efficient and accountable part of the public sector.

This response has been approved by the LGA's Resources Board.

General points

The guidance should ensure that local authorities are prudent and undertake due diligence over their investments and do so in a transparent way that ensures members understand and approve overall investment activity. Local authorities have a strong record already in this area, successfully managing investments for many years and this should be acknowledged in the framing of the guidance.

Local government has dealt with cuts in funding of £16 billion over the current decade and is facing a funding gap of £7.1 billion by the end of the decade including £1.3 billion needed to stabilise the adult social care market right now. Local authorities have coped well with these reductions to funding and increased pressures but the scope for making savings without affecting services has gone. Local authorities have been encouraged to take control of their own finances locally and to act in a commercial way. Much of the increase in investment activity in recent years has been in response to the need to find alternative funding in order to protect local services.

The prudential framework for capital finance governs local authority borrowing and ensures councils take a prudent approach to borrowing to meet their local needs. However, borrowing to fund social housing is subject to the Housing Revenue Account (HRA) Borrowing cap and this severely restricts councils' ability to invest in new housing. The HRA borrowing cap should be lifted and HRA borrowing be subject to the prudential framework in the same way as other council capital investment.

There are aspects of the proposed revisions in the Guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provisions that go beyond the formal consultation questions. We would like to comment on these and highlight the potentially serious negative consequences to council finances and ultimately services. The final guidance should be drafted to avoid these negative consequences.

Local Authority investment guidance

The consultation says the guidance has to be read in conjunction with the Cipfa Prudential code and the Cipfa Treasury Management code. These have not yet been published or finalised, so it is not possible for local authorities to fully comment on the proposals in the consultation and changes to the Guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provisions.

The LGA would like to draw attention to the combined impact of the following in the draft investment guidance and a recent draft of the Cipfa Prudential code:

“Borrowing solely to invest in a yield bearing opportunity is borrowing in advance of need” (Paragraph 40)

“Borrowing solely to invest rather than to deliver statutory services or strategic objectives has always been considered to be borrowing in advance of need” (paragraph 21)

“Authorities must not borrow in advance of need purely in order to profit from the investment of the extra sums borrowed”. (draft Cipfa Prudential code).

Taking these together the result is that under the guidance local authorities will not be able to borrow in order to invest in any yield bearing opportunities. The guidance needs to be clear if this interpretation is correct as this would be a significant problem. Under the current (2010) guidance it is clear that “borrowing in advance of need” relates solely to financial investments and financial instruments whereas investments such as commercial property rightly count as capital expenditure as they involve the acquisition of a physical asset and as such are eligible for funding from borrowing.

Local authorities have invested in property in different ways for many years; if this is to be restricted it could have a major impact on their ability to fund and deliver services to their residents. Furthermore, if this change does go ahead and is applied retrospectively, forcing councils to divest themselves of existing investments, the financial costs and potential losses could be disastrous for some councils. We oppose any restriction that will reduce funding for councils to benefit their local areas and under no circumstances should this be applied retrospectively.

Minimum Revenue Provision (MRP) guidance

As a general point it is not clear how the new Minimum Revenue Provision (MRP) guidance will be applied in practice, for example in relation to capital investment decisions already taken. These would have been based on existing MRP policies based on the existing guidance. It is not clear in this case whether it will require new calculations and adjustments to what may have already been agreed with local auditors as prudent. This will impact on how local authorities are approaching decisions they need to make now.

In addition, if the changes in rules are applied retrospectively then it will have significant implications for councils that have to change their MRP. This could have a significant impact on revenue budgets and will affect councils’ ability to deliver services. Under no circumstances should this change be applied retrospectively and this should be clarified urgently.

Response to specific Consultation Questions

Question 1 Do you agree with the proposed change (that matters required to be *disclosed in the investment strategy to be disclosed in the capital strategy)? If not, why not; and what alternative would you propose?*

This change is supported in principle.

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?

The draft guidance (para 17) clarifies that this refers to the "financial" contribution. It is good practice for such a figure to be included in councils' investment strategies, medium term financial plans and annual budgets so the LGA supports this.

The guidance also refers to "non-core" investments. Many councils have held property investments for many years, the income from which forms a core part of their budget (e.g. rental from property holdings in town and city centres). It will be difficult to define what is "core" and "non-core" in a meaningful and helpful way.

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?

We fully support transparency in decision-making and it is important that decisions are made on consistent information across years and that reflect local conditions. We are concerned, however, that paragraph 19 of the draft guidance requires that indicators should allow comparison of "a local authority's decisions to a similar authority". The practicalities of attempting this preclude it as a possibility. To attempt this would impose a major burden on councils and would require such indicators to be imposed nationally; in addition the notion of "similar authority" would need to be defined. Such indicators need to be specified locally and the requirement for national comparison in paragraph 19 is we believe ill thought through and not supported. Question 5, below, seems to contradict this and seems much more sensible.

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?

The LGA agrees with this proposal.

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

We agree with this. However, we believe it is not consistent with paragraph 19 in the draft guidance (see answer to question 3 above). Paragraph 19 should be amended accordingly.

Question 6 Do you agree with the extension of the principles of security and liquidity to non-financial 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?

The balance between security and liquidity will be different for different types of assets. For example, investment in property will prioritise security and liquidity will be less important. Non-financial assets need to be looked at differently from Treasury assets as they are held for different purposes – for example they could be held for service reasons such as part of an economic development strategy.

Undertaking Treasury activity to manage cash flow is fundamentally different to assessing the impact on a council's overall strategy arising for other investments. So long as that is accepted and made clear, this is supported.

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

We believe it is important that local authorities make their decision based on an understanding of the accumulated risk that they face. Proportionality as described in paragraphs 37 – 39 of the draft guidance is an extension of the proposals outlined in question 2 and is supported on the same basis.

Paragraph 38 of the guidance refers to a requirement to detail "opportunity cost of using borrowing capacity for investment rather than service delivery". This is unlikely to result in any disclosure and seems to be superfluous. Any borrowing for investment purposes should be more than self-financing and so not impact on other borrowing capacity.

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?

We support full disclosure of information where this does not impair commercial confidentiality. This section of the guidance (para 40) also covers the point about "borrowing in advance of need" which we refer to in the general point in our response above. Currently investment in commercial property is classified as capital expenditure and so may be financed by borrowing.

Question 10: Do you agree with the extension 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?

This seems to be an unnecessary burden. This disclosure arguably goes beyond the requirements of the Financial Conduct Authority in specifying requirements for local authorities to elect to act up to professional investor status under MiFID II, where decisions are delegated to officers, and so it is hard to see the justification for this. The disclosure requirement should be aligned with local decision making and specified locally.

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?

We agree that the definition should be based on the borrowing requirement in the capital finance requirement.

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

This is not supported. If a local authority has made over provision for MRP in the past that over provision should be credited back to the council. If this is not allowed it means that previous and current council tax payers will be subsidising future council tax payers and current service costs will be overstated. It is vital that councils retain the flexibility to review MRP within the guidance, especially within the current challenging financial context.

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?

See answer to question 12. It is unlikely that these changes in methodology will reveal that a local authority has made over provision of MRP in the past and that this will therefore generate an overpayment of MRP. But if they have then there should be flexibility for this to be credited back to the local authority if that is appropriate.

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?

This is supported in principle provided that the years specified in the guidance are seen as a guide and there is flexibility to take account of specific local conditions. In addition, if longer terms than these have already been agreed with local auditors as being prudent, these should continue to be used and not be subject to retrospective adjustments.

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

Implementing this from 2018/19 would cause significant problems for councils and the uncertainty created by a possible implementation at that date is already causing problems with decisions required to set 2018/19 budgets. Deferring implementation of any changes to 2019/20 and notifying this well in advance would give councils time to plan and implement properly.