Decision to be made by the Deputy Leader (Finance and Property) on or after 15 December 2017

Changes to the Prudential Framework of Capital Finance – Responding to the Government's Consultation

Recommendations

The Deputy Leader is asked to:

1) Approve the use of the proposed response to the consultation, attached as the **Appendix.**
2) Delegate authority to the Head of Finance to approve any further adjustments to the consultation response prior to the submission date of December 22nd 2017, providing they are consistent with the proposed responses in this report.

1. Background

1.1. The Statutory Guidance on Local Authority Investments outlines the proper practices that local authorities are required to follow when making investment decisions, while the Statutory Guidance on Minimum Revenue Provision (MRP) determines how authorities must include the impact of borrowing decisions on the annual revenue budget. The Local Government Act of 2003 gives these documents statutory status alongside the Prudential Code and the Treasury Management Code, both from CIPFA, to form the overall Prudential framework for local authorities.

1.2. The Statutory Guidance on Local Authority Investments was last updated in 2010. In the past seven years the economic landscape has changed significantly, affecting authorities' treasury management decisions. Additionally, the General Power of Competence in the Localism Act of 2011 has given local authorities more flexibility in related areas, including the use of non-financial yield bearing and other investments. This has led Government to review the guidance to reflect changes in the way local authorities now invest. The consultation suggests a number of ways to increase transparency and accessibility as investment activities broaden in nature. It also addresses measures to ensure that debt levels and aggregate risk are proportionate to the size of the authority, without discouraging investment to deliver local regeneration.

1.3. The Statutory Guidance on MRP was last updated in 2012. As resources available to local authorities have reduced in recent years, many authorities have reviewed their methodology for setting MRP charges. The consultation aims to update the guidance in response to aspects of this emerging practice, to clarify what is expected of local authorities in terms of making prudent decisions. In Warwickshire we revised our methodology in 2017 and the OOP 2020 savings plan included a £3million saving from reducing our MRP charge as a result. The delivery of this saving will not be put at risk by the proposals in the consultation paper.

1.4. This report discusses the consultation proposals for each document and briefly explains the proposed response from the Council. A full draft response is included as an **Appendix** to this report.

2. Statutory Guidance on Local Authority Investments

2.1. Many of the consultation questions centre on new ways for local authorities to report on their investment activity, including:

- A new Principle of Contribution, which will require authorities to disclose the contribution that investment decisions make to their core functions, in recognition that some investments may not be made purely on the basis of anticipated financial yield.
  Proposed response: The Council has very few non-core investments, but we believe the new Principle will provide helpful information for Councillors and other interested parties to understand decision-making in this area. We also believe that it would be helpful to provide a more detailed breakdown of underlying deposits and external funds invested so that Members are able to make a more informed judgement about financial risk.
- A requirement to enable assessment of total exposure from borrowing and investment decisions. The nature of the specific indicator(s) and any relevant thresholds will be left to the individual authority to determine.
  Proposed response: For borrowing exposure, we believe that this overlaps with the existing requirements in the Treasury Management Code and so feel this is an unnecessary addition to the Statutory Guidance on Local Authority Investments. For investments, however, this does represent a new requirement and we support its inclusion to increase transparency equally across a council's full treasury management functions. We support the suggestion that indicators are left to individual authorities as the nature of investment activity can vary significantly between councils.

- A new Concept of Proportionality which will require local authorities to disclose their dependence on commercial income and the amount of borrowing required to deliver that income.
  Proposed response: The consultation does not clearly define “commercial income” and we would argue that this is necessary to consider this requirement. It seems likely that there could be overlap with the new Principle of Contribution above and we would suggest that the two are combined into a single clearer requirement. As a guiding principle, we would not support any new reporting requirement that, in and of itself, restricted local authorities’ options to adopt any particular operational or investment model over another. Such decisions should be made, with appropriate scrutiny and governance, by assessment of the business case for the proposed activity against locally-defined measures such as fit with corporate priorities and risk appetite. External reporting requirements may support the process, but should not be formulated in such a way that restricts local decision-making and flexibility.
- A requirement for additional disclosure by authorities who borrow solely to invest in revenue generating investments.
  Proposed response: The consultation does not clearly define how it would be determined that an authority had borrowed to invest in this way and we feel this term needs clarity before we can fully consider this requirement. It may again be better to make the link with the non-core investments covered in the Principle of Contribution proposal above. We again would want to see sufficient flexibility in any reporting requirement to support, but not restrict, local decision-making.
- A requirement to disclose the steps “statutory officers, Councillors and other key individuals” have taken to ensure they have sufficient knowledge and expertise to be able to take sensible decisions in relation to Treasury Management.
  Proposed response: We believe this requirement is already enforced in the legal definitions of the requirements for statutory officer roles and in the steps required for MiFiD II compliance. We do not therefore feel it is necessary to repeat this information in the Treasury Management Strategy.

2.2 The consultation also suggests an extension of the principles of Security, Liquidity and Yield from investments in financial assets to non-financial assets. Small changes are proposed to the definitions of Security and Liquidity for this purpose.

Proposed response: The Council considers Security and Yield in all its investment decisions and has no objections to the extension of these two principles to non-financial investments. However, whilst a Liquidity principle might be helpful, it needs to recognise that some investments in the non-financial asset category have readily available liquidity but still carry a risk of reduced returns if asset prices are depressed at the point of redemption. Any definition of Liquidity should therefore reflect that whilst these assets may be readily accessible to redeem, there may be cost implications, which may be acceptable to the authority in light of the other benefits delivered by these investments.

2.3 The consultation also asks for agreement to allow the inclusion of the Investment Strategy within the Capital Strategy. This is driven by changes to the Prudential Code and is a simple legislative change to support the creation of a broader view within the Capital Strategy. This change will be reflected in the Capital Strategy presented to Council in February 2018.
Proposed response: We agree with this change.

3. Minimum Revenue Provision Guidance

3.1. Local Authorities are required to make "prudent provision" in their revenue accounts to reflect the cost of borrowing for capital expenditure. At present, the definition of "prudent provision" is connected to the useful lives of assets purchased in this way, as (non-housing) authorities otherwise recognise no charge to their usable reserves in relation to depreciation. However, the Government believes this is slightly misleading as the purpose of MRP is to make provision for debt repayments. The consultation therefore proposes a new definition centred on the gap between capital expenditure levels and the funding available through income, grants and capital receipts.
Proposed response: The new definition is very unclear from the consultation document and we feel this needs clarity before we can consider this proposal. We would only support a definition that retained the fundamental principle of equity across those generations who benefit as assets are consumed in the provision of services.

3.2 The consultation also addresses the emerging practice in some authorities of crediting the revenue account or reducing future MRP charges where a change in MRP methodology reduces the annual charge. It proposes a clear statement that credits are never allowable, and that overpayments should only be offset to reduce future charges where the overpayment was an intentional act at the time it was made, not as a result of retrospective adjustments to MRP methodology.

Proposed response: WCC has never sought to recoup prior year payments or to make credit payments back to the revenue account as it has viewed this as imprudent practice. We therefore support the clarity that this proposal brings.

3.3 Finally, the consultation proposes maximum economic lives to be applied in cases where authorities calculate MRP from asset information.
Proposed response: WCC does not directly calculate its MRP charges in this way and would be unaffected by the change. However we support the proposal to ensure prudence, though we note the need to connect to any decisions made to relate "prudent provision" more directly to debt than assets as described in section 3.1.

4. Timescale for change

4.1. The final consultation question relates to both documents and suggests an implementation date of 2018/19. This would mean that the final outcomes from this consultation would need to be reflected in the following documents:

- The Budget resolutions, including the Capital Strategy and its new extended commentary on the Council's Investment Strategy, due to be presented to Cabinet in January and Council February 2018
- The Treasury Management Strategy, due to be presented to Cabinet in February and Council in March 2018.

Proposed response: The biggest impact of the proposed changes for WCC is in relation to the Treasury disclosures described in section 2.1. The new indicators proposed in relation to investment exposure in particular will need careful review, and these may impact on the content of both the Budget resolutions and the Treasury Management Strategy, although as stated previously we do not expect there to be a financial consequence. The DCLG consultation closes on December 22nd, so any final decisions are unlikely before mid-January 2018 which makes the timescale for the potential workload very tight. Whilst we therefore support the introduction of the changes to the MRP Guidance for 2018/19, we feel it is unrealistic to expect authorities to absorb the changes to the Statutory Guidance on Local Authority Investments on the same timescale.

5. Next steps

5.1. As mentioned above the deadline for responses to DCLG is the 22nd December 2017. The attached draft response from WCC has been submitted to the Society of County Treasurers (SCT) to allow them to identify any points of consensus and/or disagreement and to submit a collective response to the

DCLG. Given the need for a rapid turnaround to meet the consultation deadlines, the second recommendation in this report asks the Portfolio Holder to delegate authority to the Head of Finance to adjust the proposed response on behalf of WCC to reflect any points picked up by SCT that we would like to support, where they are consistent with the proposed responses outlined in this report.

6. Background Papers

6.1. None.

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The following Elected Members have been consulted on this report prior to its publication:

Cllr Heather Timms, Cllr Parminder Singh Birdi, Cllr Maggie O’Rourke, Cllr Sarah Boad

Appendix

Consultation on the Proposed Changes to the Prudential Framework

Submitted by: Victoria Barnard, Corporate Finance Manager

On behalf of: Warwickshire County Council

Shire Hall, Warwick, Warwickshire CV34 4RP

01926 738816

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

We have no objection to this change.

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 Council has very few non-core investments, but we believe the new Principle will provide helpful information for Councillors and other interested parties to understand decision-making in this area.

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 also believe that it would be helpful to provide a more detailed breakdown of underlying deposits and external funds invested so that Members are able to make a more informed judgement about financial risk.

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?

For borrowing exposure, we believe that this overlaps with the existing requirements in the Treasury Management Code and so feel this is an unnecessary addition to the Statutory Guidance on Local Authority Investments. For investments, however, this does represent a new requirement and we support its inclusion to increase transparency equally across a council's full treasury management functions.

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 support the suggestion that indicators are left to individual authorities as the nature of investment activity can vary significantly between councils.

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?

The Council considers Security and Yield in all its investment decisions and has no objections to the extension of these two principles to non-financial investments. However, whilst a Liquidity principle might be helpful, it needs to recognise that some investments in the non-financial asset category have readily available liquidity but still carry a risk of reduced returns if asset prices are depressed at the point of redemption.

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

Any definition of Liquidity should reflect that whilst these assets may be readily accessible to redeem, there may be cost implications, which may be acceptable to the authority in light of the other benefits delivered by these investments.

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

The consultation does not clearly define "commercial income" and we would argue that this is necessary to consider this requirement. It seems likely that there could be overlap with the new Principle of Contribution above and we would suggest that the two are combined into a single clearer requirement. As a guiding principle, we would not support any new reporting requirement that, in and of itself, restricted local authorities' options to adopt any particular operational or investment model over another. Such decisions should be made, with appropriate scrutiny and governance, by assessment of the business case for the proposed activity against locally-defined measures such as fit with corporate priorities and risk appetite. External reporting requirements may support the process, but should not be formulated in such a way that restricts local decision-making and flexibility.

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?

The consultation does not clearly define how it would be determined that an authority had borrowed to invest in this way and we feel this term needs clarity before we can fully consider this requirement. It may again be better to make the link with the non-core investments covered in the Principle of Contribution proposal above. We again would want to see sufficient flexibility in any reporting requirement to support, but not restrict, local decision-making.

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?

We believe this requirement is already enforced in the legal definitions of the requirements for statutory officer roles and in the steps required for MiFiD II compliance. We do not therefore feel it is necessary to repeat this information in the Treasury Management Strategy.

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?

The new definition is very unclear from the consultation document and we feel this needs clarity before we can consider this proposal. We would only support a definition that retained the fundamental principle of equity across those generations who benefit as assets are consumed in the provision of services.

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?

WCC has never sought to recoup prior year payments or to make credit payments back to the revenue account as it has viewed this as imprudent practice. We therefore support the clarity that this proposal brings.

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?

Yes, we agree with the proposed approach as described in the consultation.

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?

WCC does not directly calculate its MRP charges in this way and would be unaffected by the change. However we support the proposal to ensure prudence, though we note the need to connect to any decisions made to relate “prudent provision” more directly to debt than assets as described in question 11.

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

Yes, the proposals are reasonable.

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?

The biggest impact of the proposed changes for WCC is in relation to the Treasury disclosures described in section 2.1. The new indicators proposed in relation to investment exposure in particular will need careful review, and these may impact on the content of both the Budget resolutions and the Treasury Management Strategy, although as stated previously we do not expect there to be a financial consequence. The DCLG consultation closes on December 22nd, so any final decisions are unlikely before mid-January 2018 which makes the timescale for the potential workload very tight. Whilst we therefore support the introduction of the changes to the MRP Guidance for 2018/19, we feel it is unrealistic to expect authorities to absorb the changes to the Statutory Guidance on Local Authority Investments on the same timescale.