

# ANNEX B

## Capital Finance – A Possible Prudential System

### Introduction

- B1. The present local authority capital control system operates on the basis of a highly complex and detailed body of primary and secondary legislation. A key control in the system is the credit approval issued by central Government. An authority may only borrow or enter into any other long term financing arrangement if it has a credit approval to cover the sums involved. A prudential system, on the other hand, would allow authorities to borrow freely for capital investment, subject to controls which would ensure that borrowing was affordable and consistent with national economic policy. This annex describes a possible framework for such a system. The Government believes that it would be simpler and more transparent than the present system; would enhance local decision making and accountability; and encourage more efficient and effective capital spending by removing artificial constraints over borrowing.
- B2. The new prudential system would have four main strands: primary legislation; secondary legislation; professional codes; and self-regulation.

### Primary and secondary legislation

- B3. This would consist of :
- A small core framework of capital legislation including the power for local authorities to borrow, and for the Secretary of State to regulate borrowing and ‘extended credit’ (transactions similar to borrowing)
  - A new power for the Secretary of State to set statutory prudential indicators
  - Continuing reliance on the statutory ‘balanced budget’ requirement and other prudential legislation.
- B4. The power to set **statutory prudential indicators** would be used to set a limit on the rate of increase of individual authorities’ debt, in order to avoid any excessive initial surge in aggregate spending when the new system is first introduced. Such a limit would be intended to allow enough flexibility for all authorities to carry out a reasonable level of self-financed borrowing. It is not envisaged as a permanent arrangement, although limits might exceptionally need to be re-imposed if national economic circumstances demanded it. There would also be a reserve power to restrict the right to borrow freely for individual authorities which did not operate local prudential regimes effectively, were not delivering Best Value or failed to consult voters and local stakeholders.

- B5. The aim would be to keep new primary legislation as short and simple as possible, with any necessary detail in secondary legislation. The primary legislation would at least contain a power for local authorities to borrow; and a power for the Secretary of State to regulate borrowing. All the more technical provisions would, as far as possible, be set out in regulations. The power to regulate borrowing could allow this to be achieved by reference to proper practices, and hence by professional codes. Any more formal restrictions in regulations could be of a temporary or time-limited nature. The Government's power to limit borrowing through the system of issuing credit approvals would disappear permanently.
- B6. The new system, like the present one, would need to regulate not only borrowing but also extended credit (that is, contractual arrangements with a similar effect to borrowing, such as long-term leasing and deferred purchase). While such forms of credit are not included in the measure of debt used in macro-economic controls, they are captured in 'public sector net borrowing' – the measure used for economic analysis and as background to public spending decisions. Prudential control at the local level also needs to take account of extended credit, because it carries with it the same kind of long term financing obligations as long-term borrowing.
- B7. Credit would therefore still need to be treated on a par with borrowing and be regulated in a similar way. In this annex the term "borrowing" should accordingly be taken to include the use of extended credit; and references to "debt" should be construed as including all liabilities in respect of borrowing and credit.
- B8. It might however be possible to avoid the present level of complexity in the rules on credit by relying more upon balance sheet treatments of liabilities. Under the new system, any credit liability which had to be recognised on an authority's balance sheet would be treated as an increase in the authority's borrowing. It would be taken into account in the determination of the authority's overall borrowing capacity, for purposes of measurement or longstop control. There would be no constraints on transactions, which were off-balance sheet for the authority. Private finance initiative (PFI) transactions could similarly be regulated by reference to balance sheet treatment, avoiding the need for special regulations. However, there might, as now, need to be some special provisions to exclude certain forms of credit from the controls (e.g. leases of private-sector housing used to accommodate the homeless).
- B9. In establishing the new system, a decision would have to be taken on whether there was a continuing need for an arrangement to limit the use of capital receipts to finance capital expenditure. This currently plays an important part in matching housing capital resources to relative need to spend. The existing system requires authorities to 'set-aside' a proportion of their capital receipts – mainly from council house sales – as provision for meeting borrowing and credit liabilities. Dropping this control could imply a significant increase in capital investment by authorities with relatively large housing receipts – and these are not necessarily those with greatest housing need. The 'set aside' mechanism could not continue in its present form under a system in which borrowing capacity was not precisely determined by central Government; but it may be possible to achieve broadly the same result through the allocation of Government support. As indicated in paragraph 4.13 of the Green Paper, if a prudential system is introduced, it will also be necessary to consider how to replace the current "Receipts Taken Into Account" mechanism, which also plays an important role in the distribution of capital resources.

- B10. Transactions by local authority companies would still need to be regulated under any new system of capital controls, since their expenditure has the same impact in the national accounts as that of authorities themselves. Under the present rules, authorities are required to treat borrowing by their companies as if it was their own and to score it against their capital resources in broadly the same way. The current method of control is closely integrated with the overall capital finance structure and the likely changes to the latter mean that new arrangements for companies would be needed.
- B11. There are other issues for which the present system has specific technical implications, such as the treatment of social housing grant, disabled facilities grant, EU grants, local government reorganisation and the establishment of the Greater London Authority. Though these are relatively minor in this context, they are still important and their treatment under any new system will need to be carefully considered. Consideration is also being given to the need for regulation in respect of guarantees and the policy on local authority investment.
- B12. It will also be necessary to consider a replacement for the system of Minimum Revenue Provision (MRP), under which authorities set aside amounts annually from revenue as provision for meeting debt. In principle, the Government accept that it would be preferable to have a non-statutory scheme of regular revenue provision based upon UK generally accepted accounting practices (GAAP), with a full and proper charge being made for depreciation. In the short term the difficulty is that depreciation provision would often be significantly higher than MRP, so something like the present system of MRP is likely still to be needed initially. However, consideration could be given to replacing the present complex regulations with a simpler statutory code of guidance issued by DETR.
- B13. In addition to the specific capital finance controls, there are a number of other existing statutory provisions that would have an important role in a prudential system. Of particular importance is the **balanced budget requirement**. Section 32 of the Local Government Finance Act 1992 places a duty on a local authority to calculate its budget requirement for each financial year. The budget requirement includes the revenue costs, which result from the capital investment decisions of the authority. These costs include capital financing costs (interest and loan repayment provision) and running costs. Section 33 of the Act requires the local authority to set a council tax sufficient to meet its expenditure taking into account other sources of income such as government grants and non domestic rates.
- B14. This balanced budget requirement of Sections 32 and 33 is central to the prudential framework concept. It is a high level control which provides a basic safeguard against irresponsible budgeting and is fundamental to the aim of the prudential approach which is to establish the revenue finance system as the ultimate discipline on the level of capital investment. Section 76 of the Local Government and Housing Act 1989, which requires housing authorities to budget to avoid a deficit in the Housing Revenue Account (HRA), would play a similar role in relation to housing investment.
- B15. A further complementary high level control is the statutory duties of an authority's monitoring officer and financial officer. The monitoring officer has a duty to report on matters which may give rise to contravention of law or statutory codes of practice and the financial officer has a duty to report on unlawful or potentially unlawful expenditure and on expenditure which is likely to exceed resources available. These are high level 'whistle blowing' powers and it is envisaged that elements of these powers would be invoked if statutory prudential indicators were in danger of being breached.

## Professional Regulation and Self-Regulation

- B16. With a switch away from a system heavily controlled by legislation, professional regulation and self regulation would be central to a new system. Professional codes of practice, monitoring, reporting and audit requirements have developed considerably since the present capital control framework was put in place and would be further strengthened under a prudential system.
- B17. A number of professional codes reflecting good practice and guiding authorities' actions exist:
- Code of Practice on Local Authority Accounting in Great Britain – CIPFA 1999
  - Code of Practice on Treasury Management in Local Authorities – CIPFA 1996
  - Code of Practice on a Prudential Approach to Local Authority Commitments – Local Authority Associations and Audit Commission 1989.
- B18. The key professional codes have the same force as statute and in some instances reflect statutory requirements. For example, the Code of Practice on Local Authority Accounting in Great Britain specifies that local authorities' accounts include the requirements of the Accounts and Audit Regulations 1996. The Treasury Management Code was drawn up by CIPFA in consultation with relevant bodies in response to a small number of high profile cases in the early 1990s. It was not a statutory requirement, but was introduced and adopted by all local authorities, and demonstrates the capabilities of the existing framework for self regulation. These codes provide a good framework for a prudential system, but they need to be reviewed and strengthened. For example, the Code of Practice on a Prudential Approach to Local Authority Commitments is not currently mandatory and its content and status would need to be updated under a prudential control system.
- B19. Both internal and external audit would play an important role under a prudential system. The Audit Commission has pointed to the Turnbull Committee's<sup>1</sup> conclusion that "an objective and adequately resourced internal audit function should be in a position to provide any governing body with much of the assurance it requires regarding the effectiveness of its system of internal controls". The Commission supports this view, with the caveat that internal audit services may not all yet be up to the standard required and some strengthening of the internal audit services may, therefore be necessary under a prudential system.
- B20. The external auditors' examination of authorities' activities and monitoring compliance with self-assessment controls would form part of their work in much the same way as the audit of compliance with the existing control system is a key element of the current audit.

<sup>1</sup> In 1991, the Financial Reporting Council, the London Stock Exchange and the accountancy profession established the Cadbury Committee to address the financial aspects of corporate governance. Subsequent committees built on the work of the Cadbury committee to produce the 'Combined Code of Principles of Good Governance'. The Turnbull Committee has produced further guidance on these principles.

- B21. Self-regulation by a council's own members and officers would build on the principles of best value and strategic asset management planning. The essential new element would be a core set of prudential indicators. These local prudential indicators would help make plain the impact of capital decisions on the revenue account over time and allow performance in managing capital investment to be clearly monitored and assessed.
- B22. Self-assessment measures should be seen as a practical application of the good practice concepts contained in professional codes. It is envisaged that strengthened professional codes would identify a core set of local prudential indicators covering treasury management, capital financing and actual debt levels. Within the broad constraints of professional best practice as codified in these, local authorities themselves are in the best position to determine the precise indicators that would deliver effective management information. As such, the indicators should not be used for league tables, but should represent a range of issues which authorities might take into account when setting capital and revenue budgets.
- B23. Locally set prudential indicators should be easily collected and, most of all useful for local authorities to measure. The indicators would be set by local authorities at the planning and budgeting stage and would guide decision making and subsequent monitoring by members. The indicators might be calculated for the whole of the medium term planning period: 3 to 5 years forward. The level of and change in the indicators over the planning period, rather than their absolute value would therefore be the key consideration. It is envisaged that authorities' actual financial position in relation to its locally set prudential indicators will be an important factor in the considerations of Section 151 Officers.<sup>2</sup>
- B24. The process of setting and monitoring performance against local prudential indicators would enable authorities to have a proper debate about the potential consequences of their proposed investment policies, and transparency and accountability would be enhanced.

## Housing Issues

- B25. The rules governing the treatment of capital expenditure and receipts in respect of council housing are based on the capital finance system. It will therefore be necessary to consider the impact of any changes to that system on both the ring-fenced HRA and the separate HRA subsidy system. It will also be necessary to consider the implications of any changes for housing services funded from authorities' General Funds, including private sector renewal grants.
- B26. The key housing policy issues which would need to be addressed are:
- how to allocate revenue support – to ensure that (a) adequate account is taken of the need for capital expenditure on housing, both nationally and between authorities, and (b) Ministers' priorities, such as tackling the repairs backlog on authorities' own stock and private sector renewal, are met – if credit approvals are abolished;
  - the implications for the distribution of housing capital resources, for Social Housing Grant and for large scale voluntary transfers if the statutory set-aside of housing capital receipts is abolished.

<sup>2</sup> Section 151 of the Local Government Act 1972 requires local authorities to make arrangements for the proper administration of their financial affairs and to nominate an officer to have responsibility for the financial affairs.

- B27. There are also a number of detailed technical issues that would need to be addressed in taking forward the work outlined above. These include the measurement of HRA debt and the calculation of revenue support, the treatment of HRA-related credit arrangements and PFI schemes, the continuing need for housing MRP, and the need for separate prudential indicators for the HRA. These would need to be considered in the context of the ring-fenced HRA and the introduction of resource accounting, including the new Major Repairs Allowance, from 1 April 2001.