CIPFA The Chartered Institute of Public Finance & Accountancy

treasury management

in the Public Services

Guidance Notes for Local Authorities including Police Authorities and Fire Authorities

2011 Edition

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Foreword

These guidance notes replace those issued by CIPFA in 2009. They have been updated following developments resulting from the Localism Act 2011, including housing finance reform and the introduction of the General Power of Competence. There is therefore a new chapter covering the treasury management implications of the housing reforms and expansion of the risk management chapter.

The opportunity has been taken to update the statistics contained in the 2009 version, and to make certain other changes of detail.

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SECTION 1
Introduction

Treasury management in local government continues to be a highly important activity.

In 2002, CIPFA published *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* (The TM Code). At the same time, it issued sector-specific guidance notes in respect of the main categories of public service organisations, including local authorities. In 2009 the TM Code was fully revised, and it was updated again in 2011. CIPFA has also taken the opportunity to update these local authority specific guidance notes.

Local authority investments were placed under the national spotlight following the collapse of the Icelandic banks, with almost £1bn invested with the affected banks. The Audit Commission published their *Risk and Return* report in March 2009. The Department for Communities and Local Government (DCLG) Select Committee also reviewed local authority investments and produced a report with a number of recommendations. The previous version of these guidance notes was updated to respond to the recommendations of these two reports.

There are some 500 local authorities in Great Britain and Northern Ireland, including police authorities and fire authorities, carrying out a wide range of statutory functions and services. Together, they manage around £68bn of debt, have cash balances of around £25bn, and spend in excess of £100bn annually. They receive around 77% of their income from central government/devolved administration grants and subsidies, the balance coming from local taxes and charges for services.

These guidance notes should be read in conjunction with the TM Code.

SECTION 2

Status of the Treasury Management Code and purpose of these guidance notes

LEGAL STATUS

The legal status of the TM Code derives in England and Wales from regulations issued under the Local Government Act 2003 (the 2003 Act) and in Scotland under the Local Government in Scotland Act 2003 (the 2003 Scotland Act). The Capital Finance and Accounting Regulations[1] explicitly require English and Welsh authorities to *'have regard'* to the TM Code. In Scotland, Finance Circular 5/2010[2] requires local authorities to *'have regard'* to the CIPFA Prudential Code[3] and the TM Code. In Northern Ireland, the Local Government Finance Act (Northern Ireland) 2011 (the 2011 Act) introduces the Prudential Framework and therefore the need to adopt the TM Code.

The TM Code and the Prudential Code are closely linked. All authorities in the UK are required to have regard to the Prudential Code when setting limits to the level of their affordable borrowing under section 3(5) of the 2003 Act (in England and Wales), under section 13(1) of the 2011 Act (Northern Ireland), or (in Scotland) the maximum amount they can afford to allocate to capital expenditure under section 35 of the 2003 Scotland Act.

The provisions of the Prudential Code, including those that relate specifically to treasury management, together with the wider provisions of the Prudential Code in the self-regulation of local authority capital finance, are described in section 5 of these guidance notes. However, for a complete guide to the Prudential Code, reference should be made to the CIPFA publication *The Prudential Code for Capital Finance in Local Authorities: Fully Revised Guidance Notes for Practitioners* (the Prudential Code guidance).

The Prudential Code has also been reviewed and an updated version published.

1. The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), Regulation 24, and the Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 (Welsh SI 2003/3239/W.319), Regulation 19.
2. Finance Circular 5/2010 *The Investment of Money by Scottish Local Authorities* (The Scottish Government, 2010).
3. *The Prudential Code for Capital Finance in Local Authorities (2011 Edition)* (CIPFA, 2011).

PURPOSE OF THE GUIDANCE NOTES

These guidance notes:

- propose how local authorities might adapt the treasury management practices (TMPs) and suggested schedules in sections 1 and 2 of the cross-sectoral guidance notes
- draw attention to common practices and current issues particular to the treasury management activities of local authorities.

CIPFA'S STANDARD OF PROFESSIONAL PRACTICE

The relationship between the TM Code and CIPFA's *Standards of Professional Practice* (September 2002) (the SoPP) should be noted. The SoPP states that:

- *The SoPP applies to individual CIPFA members, whereas the TM Code applies to any organisation that has adopted it as part of its standing orders, financial regulations or other formal documents appropriate to its circumstances.*
- *Non-compliance with the TM Code by a CIPFA member whilst employed by, or undertaking work for, an organisation that has adopted the TM Code may be considered as a material factor in any disciplinary action under the Institute's bye-laws.*

SECTION 3

The treasury management powers and activities of local authorities

STATUTORY REQUIREMENTS

Local authorities' treasury management activities are prescribed by statute. The sources of their powers are, in England and Wales, the 2003 Act; in Scotland, the 2003 Scotland Act; and in Northern Ireland, the 2011 Act. The provisions of these Acts simplified past complexities and clarified particular uncertainties under previous legislation.

Essentially, a local authority in England, Wales or Northern Ireland may borrow or invest for any purpose relevant to its functions, under any enactment, or *'for the purpose of the prudent management of its financial affairs'*. A local authority in Scotland can invest money in accordance with the regulations.

In England and Wales under the 2003 Act, and in Northern Ireland under the 2011 Act, a local authority is required to determine and keep under review how much money it can afford to borrow. In Scotland, under the 2003 Scotland Act, a local authority is required to determine and keep under review the maximum amount that it can afford to allocate to capital expenditure.

Local authorities may borrow only in sterling (except with the consent of HM Treasury).

Local authorities are not constrained by law in the types of investments they may make or the investment instruments they may use. However, in England and Wales, they are in practice constrained by DCLG guidance[4] and Welsh Government guidance,[5] each of which was updated in 2010. They both stress the prudent investment strategy of security, liquidity and yield. This means that first and foremost local authorities must ensure the security of their principal sum invested, ie ensure that they get back their full investment. Then they should ensure that they have the liquidity they need, ie that they have funds available when needed, and so should consider the length of an investment. Only when these two are satisfied should the yield or return on the investment be considered.

The investment regulations also distinguish between 'specified' and 'non-specified' investments, the latter (which include equity-type investments) requiring greater scrutiny by authorities.

4. *Guidance on Local Government Investments* (DCLG, 2010).

5. *Guidance on Local Government Investments* (Welsh Government, 2010).

In Scotland the Local Government Investments (Scotland) Regulations 2010 set out the requirement for a local authority to obtain the consent of Scottish ministers to make investments. This is provided by the Scottish Government in Finance Circular 5/2010.

The Scottish regulations also require local authorities to manage their investments in a way that minimises the risk to the capital sum and optimises the return on the funds consistent with those risks.

Equity-type investments are defined as capital expenditure, the effect of which, if used, is to reduce an authority's scope for funding capital projects. There is an exemption in England if shares and bonds are acquired through collective investment schemes, such as unit trusts, because such funds spread and reduce risk, while allowing easy access to cash. In Wales, SI 2004/2010 provides exemption subject to certain conditions. In Scotland, the investment regulations define loan and share capital as investments.

The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007 (SI 2007/573) added real estate investment trusts (REITs) to the list of investments which are exempted from the requirement for local authorities in England to define them as capital expenditure. The Capital Finance Amendment Regulations (SI 2010/454) also exempt the acquisition of shares in an investment scheme approved under the Trustee Investments Act 1961.

LOCAL AUTHORITY BORROWING

Historically, local authorities have satisfied the bulk of their borrowing needs from the Public Works Loan Board (PWLB) (or Government Loans Fund in Northern Ireland), providing a backbone of relatively long-term, largely fixed rate debt. At 31 March 2011, £53.1bn of local authority debt was from the PWLB. The benefit of the lending arrangements offered by the PWLB, which include both fixed rate and variable rate facilities, together with local authorities' high credit standing, has meant that they are perceived as facing little or no prospect of difficulties in refinancing their debt on very favourable terms.

The resulting certainty and stability of their interest rate exposures has been tempered over time by the use of borrowing and interest rate management techniques designed to provide a degree of flexibility not wholly afforded by the PWLB's lending arrangements. This has been achieved through:

- debt restructuring programmes, to improve the maturity profile of debt, to effect reductions in interest charges, and to redistribute between years of account the taxation burden of debt financing costs
- the use of money market instruments employing low-start or stepped interest structures
- loan structures commonly referred to as LOBOs (Lender's Option, Borrower's Option), incorporating options, the value of which can provide beneficial terms to the borrowing authority.

A marked trend in the last 20 years or so has been the increasing numbers of authorities which have become debt-free, mainly as a result of asset sales, notably council housing stock. This has led to more and more authorities being able to identify the existence of substantial amounts of core cash, and the development of their investment policies and practices to take advantage of the more permanent nature of their reserves.

The October 2010 Comprehensive Spending Review increased the PWLB rate to 1% above the gilt yield. This has had the impact of opening up the local authority capital market, with authorities now considering alternatives to PWLB. These include the issuing of bonds. In addition the housing finance reforms will mean that a number of authorities who are debt free prior to the settlement will need to raise funds to finance their settlement payment. The government announced in late September 2011 that it would return to the pre-October 2010 PWLB rate for borrowing associated with the housing finance reforms. This effectively rules out the use of capital markets for this transaction.

LOCAL AUTHORITY INVESTMENTS

The wider investment powers afforded by the investment guidance have not led to a widespread use of alternative instruments and, at 31 March 2011, 79% of English local authority cash investments were still represented by cash deposits with banks and building societies.

SECTION 4

The credit standing of local authorities

The key provisions underpinning the perceived high credit standing of local authorities are:

- the legislative requirements
- the requirements of the investment guidance
- proper accounting practices
- the Prudential Code
- the TM Code.

These all place clear corporate governance/reporting requirements on local authorities and provide the framework to ensure that local authorities' finances are sustainable and investments affordable.

STATUTORY REQUIREMENTS

There are a number of statutory requirements which underpin the high credit standing of local authorities. The key areas are detailed below:

Local Government Finance Act 1992 (the 1992 Act)

The 1992 Act requires a local authority to calculate its budget requirement for each financial year, including the revenue costs which flow from capital financing decisions. The 1992 Act requires an authority to set a council tax sufficient to meet its expenditure after taking into account other sources of income. This is known as the 'balanced budget requirement'.

Local Government Act 2003 (the 2003 Act)

The 2003 Act, the 2011 Act and the 2003 Scotland Act require local authorities to create and keep under review the limits of how much money they can afford to borrow (in England, Wales and Northern Ireland) or allocate to capital expenditure (in Scotland). The processes authorities must follow in setting these limits are described in the Prudential Code, to which authorities must have regard.

The 2003 Act and the 2011 Act state that a lender to local authorities in England, Wales or Northern Ireland *'shall not be bound to enquire whether a local authority has power to borrow money and shall not be prejudiced by the absence of any such power'.*

The 2003 Act and the 2011 Act also:

- prevent an authority in England, Wales or Northern Ireland from mortgaging or charging any of its property or assets as security for borrowings or amounts it otherwise owes
- provide for all borrowings, including interest, to be charged indifferently on all the authority's revenues
- provide for all securities created to rank equally without priority.

The 2003 Act, the 2011 Act and the 2003 Scotland Act give the Government and devolved administrations the power, in exceptional circumstances, to intervene in the self-regulatory process if:

- either they consider an authority plans to undertake borrowing or incur expenditure that is considered unaffordable, imprudent or unsustainable
- or if macro-economic reasons demand, to set limits to the overall level of borrowing and capital expenditure of all authorities.

These powers have not yet been used.

THE ENGLAND AND WALES REGULATIONS

The England and Wales Regulations place on local authorities in England[6] and Wales[7] a duty to charge to the revenue account a 'minimum revenue provision' which is deemed to be prudent.

PUBLIC WORKS LOAN BOARD

The PWLB is a statutory body operating within the United Kingdom Debt Management Office, an executive agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.

The PWLB will not lend to an authority that has acted unlawfully and will generally lend to an authority up to its available capacity within its legal borrowing limit. In dealing with applications the PWLB's officers will ask the local authority for certain information to assure the PWLB that the authority is acting appropriately and within the statutory framework. The PWLB is required to satisfy itself that a local authority has sufficient security for repayment, before making a loan, however given that loans are automatically secured by statute on the revenues of the authority, no formal checks are generally required at the point of lending. The PWLB is the lender of last resort for authorities in England, Wales and Scotland.

The Prudential Code, proper accounting practices and the TM Code are described more fully in sections 5, 6 and 8 respectively.

6. The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.
7. The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008.

SECTION 5

The Prudential Code

The Prudential Code requires authorities to self-regulate the affordability, prudence and sustainability of their capital expenditure and borrowing plans, by setting estimates and limits, and by publishing actuals, for a range of prudential indicators. It also requires them to ensure their treasury management practices are in accordance with good practice.

The Prudential Code imposes on local authorities clear governance procedures for setting and revising of prudential indicators, and describes the matters to which an authority will have regard when doing so. This is designed to deliver accountability in taking capital financing, borrowing and treasury management decisions. A fundamental provision of the Prudential Code is that over the medium term net borrowing will only be for a capital purpose. There are a number of treasury indicators which previously formed part of the Prudential Code, but which are now more appropriately linked to the TM Code and guidance. Local authorities are still required to *'have regard'* to these treasury indicators.

The key treasury indicators which are still part of the Prudential Code are:

- authorised limit for external debt
- operational boundary for external debt
- actual external debt.

The above indicators focus on the position for gross external debt. That said, it is important that a local authority understands its gross and net debt position and, where the two differ significantly, is able to explain the reasons and policy behind why this is the case. In the interests of transparency and to improve decision making, both the reasons for any significant difference between gross and net debt and the risks and benefits associated with this strategy should be clearly placed before councillors as part of their agreement of the annual treasury management strategy.

Local authorities are reminded that they should never borrow for the explicit purpose of re-investment.

In addition the following treasury management indicators are part of the TM Code:

- upper limits on the proportion of net debt compared to gross debt
- upper limits on fixed interest and variable interest exposures
- upper and lower limits to the maturity structure of its borrowing
- upper limits to the total of principal sums invested longer than 364 days.

The setting and revising of all the prudential indicators, including the treasury management indicators, should follow the same route as the setting and revising of the budget of the local authority.

Local authorities are encouraged to consider the use of local indicators where these are more appropriate to their circumstances. The treasury management indicators are detailed in full below.

TREASURY INDICATORS WITHIN THE PRUDENTIAL CODE

Acceptance of the CIPFA TM Code

The first treasury management indicator is that the local authority has adopted the CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

Authorised limit

The local authority will set for the forthcoming financial year and the following two financial years an authorised limit for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator will be referred to as the authorised limit and shall be expressed in the following manner:

Authorised limit for external debt = authorised limit for borrowing + authorised limit for other long-term liabilities

For years 1, 2 and 3

Operational boundary

The local authority will also set for the forthcoming financial year and the following two financial years an operational boundary for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator will be referred to as the operational boundary and shall be expressed in the following manner:

Operational boundary for external debt = operational boundary for borrowing + operational boundary for other long-term liabilities.

For years 1, 2 and 3

Both the authorised limit and the operational boundary need to be consistent with the authority's plans for capital expenditure and financing; and with its treasury management policy statement and practices.

The operational boundary should be based on the authority's estimate of most likely, ie prudent, but not worst-case scenario. Risk analysis and risk management strategies should be taken into account. The operational boundary should equate to the maximum level of external debt projected by this estimate. Thus, the operational boundary links directly to the authority's plans for capital expenditure; its estimates of capital financing requirement; and its estimate of cash flow requirements for the year for all purposes. The operational boundary is a key management tool for in-year monitoring as described in the Prudential Code:

It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate.

Thus, both the operational boundary and the authorised limit will be based on the authority's plans. The authority will need to assure itself that these plans are affordable and prudent. The authorised limit will in addition need to provide headroom over and above the operational boundary sufficient for example for unusual cash movements.

Actual external debt

After the year-end, the closing balance for actual gross borrowing plus (separately) other long-term liabilities will be obtained directly from the local authority's balance sheet. This prudential indicator will be referred to as actual external debt and shall be expressed in the following manner:

> Actual external debt as at xx/xx/xx = actual borrowing as at xx/xx/xx + actual other long-term liabilities as at xx/xx/xx

The prudential indicator for actual external debt considers a single point in time and hence is only directly comparable to the authorised limit and operational boundary at that point in time. Actual external debt during the year can be compared.

TREASURY INDICATORS WITHIN THE TM CODE

Gross and net debt

The local authority will set for the forthcoming year and the following two financial years upper limits on the proportion of net debt compared to gross debt. This can be an absolute amount or as a percentage.

This will be calculated as follows:

Either

> The amount of gross debt less investments

or

> The amount of net debt expressed as a percentage of gross debt.

The effect of setting this indicator is to highlight where an authority may be borrowing in advance of need.

Interest rate exposures

The local authority will set for the forthcoming financial year and the following two financial years upper limits to its exposures to the effects of changes in interest rates. These indicators will relate to both fixed interest rates and variable interest rates and will be referred to respectively as the upper limits on fixed interest rate and variable interest rate exposures.

The upper limits on fixed interest rate and variable interest rate exposures may be expressed either as absolute amounts or as percentages. They may be related either to the authority's net interest on or to its net principal sum outstanding on its borrowing/investments.

The upper limit on fixed interest rate exposures shall be calculated as follows:

Either

Interest payable on borrowing at fixed rates

Less

Interest receivable on investments that are fixed rate investments

For years 1, 2 and 3

Or

Principal sums outstanding in respect of borrowing at fixed rates

Less

Principal sums outstanding in respect of investments that are fixed rate investments

For years 1, 2 and 3

The upper limit on variable interest rate exposures shall be calculated as for fixed interest rate exposures, but substituting 'variable rates' for 'fixed rates'.

In cases where the terms of the borrowing or investment raise questions as to whether it should be treated as fixed or variable, it should be treated as being variable for the purposes of these prudential indicators.

The effect of setting these upper limits is to provide ranges within which the authority will manage its exposures to fixed and variable rates of interest.

It is expected that for most authorities the interest rate exposure calculations will result in a positive figure. However for local authorities that do not have borrowings, and for some other authorities with substantial cash investments, these calculations will result in a negative figure.

Maturity structure of borrowing

The local authority will set for the forthcoming financial year both upper and lower limits with respect to the maturity structure of its borrowing. These prudential indicators will be referred to as the upper and lower limits respectively for the maturity structure of borrowing and shall be calculated as follows:

Amount of projected borrowing that is fixed rate maturing in each period

Expressed as a percentage of:

Total projected borrowing that is fixed rate

Where the periods in question are:

- under 12 months
- 12 months and within 24 months
- 24 months and within five years
- five years and within 10 years
- 10 years and above.

For many local authorities their debt is typically very long term, and so for many most of their debt will be in the '10 years and above' maturity period. If this is the case, authorities should break down the period in excess of 10 years into several ranges, if significant debt is held in those periods; eg 10 to 20 years, 20 to 30 years.

The maturity of borrowing should be determined by reference to the earliest date on which the lender can require payment. If the lender has the right to increase the interest rate payable without limit, such as in a LOBO loan, this should be treated as a right to require repayment.

Revisions to limits on interest rate exposures and maturity structure of borrowing

Where indicators for interest rate exposures and/or the maturity structure of borrowing are revised during the financial year, the time periods under 12 months/12 months and within 24 months, etc shall refer to the time periods within 12 months of the start of the financial year/from 12 months and within 24 months, etc respectively.

When setting the treasury limits for interest rate exposures and the maturity structure of borrowing, local authorities are encouraged to start by defining their own 'benchmark' interest rate exposure and maturity profile position, and then setting limits which relate logically to that benchmark. The purpose of a benchmark is to establish the level of risk which the authority regards as its balanced or normal position, so that it can take measured decisions about whether to be 'overweight' or 'underweight' in relation to that risk. This enables clearer management of interest rate risks against the benchmark, rather than implying that any position within the upper and lower limits is equal in terms of risk.

Authorities may wish to report and agree the benchmark level as part of setting the prudential limits.

Total principal sums invested for periods longer than 364 days

Where a local authority invests, or plans to invest, for periods longer than 364 days, the local authority will set an upper limit for each forward financial year period for the maturing of such investments. These prudential indicators will be referred to as prudential limits for principal sums invested for periods longer than 364 days and shall be calculated as follows:

Total principal sum invested to final maturities beyond the period end

For years 1, 2, 3, etc

The purpose of the prudential limits for principal sums invested for periods longer than 364 days is for the local authority to contain its exposure to the possibility of loss that might arise as a result of its having to seek early repayment or redemption of principal sums invested.

In all cases, the process of setting prudential indicators for treasury management should be led by a clear and integrated forward treasury management strategy, and recognition of the pre-existing structure of the authority's borrowing and investment portfolios.

Local authorities are reminded that the prime policy objectives of their investment activities are the security and liquidity of funds, and they should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider the return on their investments; however, this should not be at the expense of security and liquidity. It is therefore important that authorities adopt an appropriate approach to risk management with regards to their investment activities. Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. Authorities should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds. These principles should be borne in mind when investments are made, particularly for the medium to long term.

Credit risk

There is no specific recommended indicator in relation to credit risk. Authorities may wish to design and set their own indicators in relation to this.

SECTION 6

Accounting for treasury management

Local authorities are required to follow proper accounting practices as specified in the *Code of Practice on Local Authority Accounting in the United Kingdom* (Code of Practice). This sets out the accounting treatment and disclosures for all normal transactions of a local authority, and defines proper accounting practice for local authorities in England, Wales, Scotland and Northern Ireland.

The requirements include:

- that the statement of accounting practices should explain the basis of calculating and charging interest charges, the redemption of debt, leases, PFI charges and investments
- that information should be disclosed in notes to their accounts on charges to revenue in respect of the minimum revenue provision for loan repayments (England, Wales and Northern Ireland only)
- that the balance sheet should include information on investments, leases and borrowings (including, in respect of longer-term borrowing, an analysis by type of lender and maturity)
- that a consolidated cash flow statement should disclose purchases and sales of investments, and the returns on them, and loans raised and repaid.

The Code of Practice is reviewed continuously and is normally updated annually.

The Code of Practice has a chapter on financial instruments which was introduced to meet the requirements of International Financial Reporting Standards (IFRSs). It includes the accounting treatment, presentation and disclosure requirements for local authorities using those instruments.

Authorities are required initially to measure and account for borrowings at fair value plus transaction costs, but then to carry them at amortised cost, with interest charges being calculated using the 'effective interest rate method' (EIR).[8]

For investments, authorities, for accounting purposes, have to distinguish between loans and receivables (which include cash deposits with banks and building societies) and 'available-for-sale assets', which include negotiable instruments such as gilts and certificates of deposit. Loans and receivables are accounted for as a mirror image of borrowings, whereas available-for-sale assets are accounted for on a fair value basis throughout their life.

8. The EIR is a means of reflecting in an authority's accounts the true economic substance of a transaction in each accounting and reporting period.

The Code of Practice guidance notes[9] set out in detail the practical accounting implications for local authority debt and investment practices. In respect of debt management, there are implications for the treatment of loans where interest is not charged on a constant basis and, potentially, to situations where alterations are made to the maturity structure or interest terms of existing loans. With regard to contemporary treasury management techniques, this impacts especially on loans involving stepped interest arrangements, and where debt restructuring techniques are employed.

A particular issue results from the distinction drawn in the Code of Practice between the 'modification' and 'extinguishment' of loans which are repaid prematurely and the effects of this on premiums and discounts incurred as a result of local authority debt restructuring practices. Whilst a distinction is required to be made for accounting purposes, the taxation effects of this distinction have been mitigated by Regulations.[10] Whilst differences exist between the effects of these Regulations in England, in Wales and in Scotland, they all allow authorities to make 'below the line' adjustments in order to spread the impact of such premiums and discounts, with effect from the financial year 2007/08.

Similarly, with effect from the financial year 2007/08, the potential impact on taxation of the use of the EIR in respect of stepped interest loans has been mitigated by Regulations[11] for loans taken out prior to 7 November 2007.

Significant issues for local authority investment management activities arise from the Code of Practice's requirements. They include potential changes in the investment practices and reporting arrangements for both external and internal cash investment management and, in particular, the impact of the changes in the treatment of unrealised gains and losses on available-for-sale assets, especially in respect of managing the volatility of market values of investments. These, too, are described fully in the Code of Practice guidance notes.

Local authorities are required to make extensive disclosures about their use of financial instruments, and to set out the objectives, policies and processes which are in place for managing and controlling the associated risks. The disclosures go well beyond the type of information which, historically, was contained in local authorities' treasury and investment management strategy reports. The required information is designed to help users of local authority financial statements to evaluate the significance of financial instruments for an authority's financial position and performance, and the nature and extent of the risks arising.

9. *Code of Practice on Local Authority Accounting in the United Kingdom: Guidance Notes for Practitioners* (CIPFA, annual).

10. The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007 (SI 2007 No. 573) and the Local Authorities (Capital Finance and Accounting) (Amendment) (Wales) Regulations 2007 (SI No. 1051 (W.108)). In Scotland, guidance under section 12 (2)(b) of the Local Government in Scotland Act dated 30 March 2007.

11. In England, under the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI No. 414); in Wales, under the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008; and in Scotland, by the guidance detailed in note 10 above.

The Code of Practice covers the principles of hedge accounting. Hedging is the process of entering into a derivative contract with a counterparty in the expectation that the transaction will eliminate or reduce exposure to a particular risk, such as movements in interest rates. Risk reduction is obtained because the derivative's value or cash flows are expected to move in the opposite direction to changes in the value or cash flows of the hedged item.

Where hedging is used, the Code of Practice permits hedge accounting to be applied, but relies on practitioners to make direct reference to the provisions in IAS 39 for the accounting treatment and IAS 32 and IFRS 7 for presentation and disclosure requirements.

The purpose of hedge accounting is to change the usual accounting treatment of a hedging instrument or a hedged item to enable the gains and losses for both the hedging instrument and the hedged item to be recognised in the same period, the aim being to reduce significant distortions because of gains/losses. FRS 26 only allows hedge accounting where the hedging relationship is designated and formally recorded at inception and for as long as the hedge remains 'highly effective'.

IAS 39 does not make hedge accounting mandatory where hedging relationships have been entered into and entities can account for assets and liabilities separately.

Authorities are only likely to opt for hedge accounting where separate accounting will result in an imbalance of gains and losses across financial years that introduces volatility that would have a substantial impact on council tax.

SECTION 7

Local authorities and the risk management agenda

The risk management agenda in local government, as elsewhere, has become increasingly high profile, especially as a result of the unprecedented levels of market volatility that have occurred in recent times. It is an issue frequently raised by practitioners.

The recent turmoil in the financial markets has led to uncertainty for the world's economies. The impact on local authorities' policies and practices with regard to their assessment of the credit standing of the counterparties they deal with has been a particularly important concern. In such conditions, the need to protect capital whilst at the same time maintaining investment returns has presented practical day-to-day challenges for local authority dealing staff, their advisers, bankers and brokers.

There has been much debate about the reliance placed by local authorities on counter-parties' credit ratings. Credit ratings are an important source of information but it is important to realise that they do have limitations. Authorities are advised to have regard to the ratings issued by the three main agencies – Fitch, Moody's and Standard & Poor's – and to make their decisions based on all ratings. Ratings should be kept under regular review and 'ratings watch' notices acted upon.

Credit ratings should not be relied upon in isolation in order to identify counterparties, but should be considered alongside generally available market information. Other sources of information should also be reviewed by authorities. These include the quality financial press, market data and information on government support for banks, including the ability and willingness of the relevant government to provide adequate support. An authority should define what it means by a high or strong credit rating in order that its treasury management strategy is clear and its approach to risk is transparent.

In considering limits with counterparties, consideration should also be given to sector, group and country limits.

Changes made by the PWLB,[12] especially in its arrangements for calculating premiums and discounts on the premature repayment of loans, have also impacted on local authority perceptions of risk in their debt management activities, and have created difficulties for authorities when trying to pursue the benefits which can flow from actively managing their borrowing portfolios.

The requirements of the Code of Practice, particularly concerning disclosures about local authorities' use of financial instruments, have resulted in the need to re-examine past approaches to risk evaluation.

12. PWLB Circulars 140 (16 October 2007), 141 (31 October 2007) and 147 (20 October 2010).

In light of these several developments, CIPFA launched a discussion in October 2008 on how best to promote the practice of active and effective risk management in local government, in order to raise awareness of the issues involved. A toolkit to assist local authorities in the practical management of risk is planned.

Local authorities are financially risk averse and greatly value revenue budget stability. The volatility of variable rate loans can be a major risk to council tax levels, so, assuming a neutral view on the level and direction of long-term interest rates, authorities would tend to borrow mainly long-term fixed rate loans. For example, an authority with a debt portfolio of £500m might not wish to be exposed to more than £1m revenue cost volatility in its interest budget for every 1% movement in variable rates. It would therefore limit its short-term and variable rate loans to £100m, requiring at least £400m to be in long-term fixed interest loans with a wide spread of maturities. Authorities may well be prepared to pay (or accept the risk of) higher interest rates for the certainty of fixed rate loans.

Authorities also tend to maintain very long-term loan portfolios because they are financing mainly long-life assets – infrastructure assets, land and buildings. The different methods available for the charging of minimum revenue provision enable a prudent charge to be made, which may be in line with the life of the asset.

With such long-dated debt portfolios, changing market and local authority circumstances make it appropriate to continuously review existing loans and investments. This is likely to include periodically repaying or restructuring long-term loans, if the terms are suitable – even at the risk of incurring repayment premiums due to adverse interest rate movements.

Risk management guidance (both in a general and in a treasury management context) makes it clear that doing nothing does not avoid or minimise risks. A risk can also be in the failure to take advantage of opportunities to optimise the council achieving its planned objectives.

A general principle behind local authority treasury risk management is that such activity should reduce the underlying treasury risks. Local authorities should not increase their risks beyond their underlying treasury exposures with a view to making a profit or speculating.

In the light of the guidance above, local authority treasury risk management could be defined as 'the ongoing activity of adjusting the authority's treasury exposures due to changing market or domestic circumstances, in order to manage risks and achieve better value in relation to the authority's objectives'. The key point is that circumstances can change after a loan or investment is made: market conditions change, affecting an authority's risk exposure, and the authority itself may change over time in its financial position (eg the level of debt), or its objectives, or its level of risk acceptance.

In relation to interest rate risk, debt management and cash investment management are each other's mirror image. For both debt and investment portfolios, authorities (or their fund managers) seek to borrow or invest according to where they perceive good value in the structure of interest rates (the yield curve). They will repay borrowings or sell investments to adjust their portfolios as the yield curve changes, in order to improve the portfolio return and adjust the incidence of risks, within agreed risk limits (such as the prudential limits for treasury management). In this context, PWLB loan rescheduling was essentially the same activity as fund managers use to seek good value by buying and selling gilts within defined portfolio objectives and limits.

It is essential that where authorities are considering the use of financial instruments to manage treasury management risks, they should always:

- ensure that they have the legal power to enter into such transactions
- define clearly their approach to risk management and the use of such tools in their treasury management strategy
- clearly state the instruments that they propose to use and in what circumstances
- only use such financial instruments for the prudent management of their financial affairs and never for speculative purposes
- seek proper advice and consider that advice when entering into arrangements to use such products to ensure that they fully understand those products.
- satisfy themselves that they understand fully how underlying risks are affected and any additional risks that may result.

In order to assist authorities in ensuring that staff are appropriately trained, CIPFA launched a qualification in treasury management which it has developed in partnership with the Association of Corporate Treasurers which is aimed at the public sector market.

CIPFA has reviewed its 2005 guidance on the subject of money laundering, and published *Combating Financial Crime: Further Guidance on Anti-money Laundering for Public Service Organisations* in 2009.

SECTION 8

Reporting on treasury management

Local authorities are required to report on specific elements of treasury management as determined by:

- the TM Code
- the Prudential Code
- the 2010 investment guidance for England and Wales
- the Local Government Investments (Scotland) Regulations 2010
- the requirements of IFRSs.

The key features of the first three are listed below and, although they represent three separate requirements, in practice many local authorities combine them into a single, coordinated, reporting process. The requirements of IFRSs are covered in section 6.

THE TM CODE

Treasury Management Practice (TMP) 6 *Reporting requirements and management information arrangements* recommends that local authorities should, as a minimum, report annually to full council on their treasury management strategy and plan, before the start of the year; report the position mid-year; and prepare an annual report on the performance, effects of decisions taken and borrowings executed, and circumstances of non-compliance with their policies, after the year-end.

The treasury management indicators must be considered together with the treasury management indicators in the Prudential Code as part of the budget approval process. The mid-year and annual post-year reports should also report on all treasury management indicators.

The chief finance officer must establish the reporting and monitoring processes, and integrate the treasury management indicators into the overall financial planning process.

THE PRUDENTIAL CODE

The Prudential Code requires local authorities to set and revise prudential indicators, and to publish actuals, in respect of those items described in section 5. It requires the prudential indicator to be approved and revised by the same body that sanctions the authority's budget.

THE 2010 INVESTMENT GUIDANCE

The 2010 investment guidance requires that authorities in England and Wales produce an investment strategy, approved and, if necessary, amended by the full council (or closest equivalent level), to be made publicly available. It should set out the policies for managing investments and for giving priority to the security and liquidity of those investments.

In particular, the investment strategy should include the following:

- the extent to which the authority's assessment of credit risk depends on the use of credit ratings, and where they are used, how frequently they are monitored and the action to be taken when they change
- the meaning given by the authority to 'high credit quality' when identifying specified investments and more details in relation to non-specified investments
- the procedures for determining the maximum periods for which funds may be prudently committed
- how the authority uses treasury management advisers and what measures are in place to maintain an appropriate quality of service
- the procedures for reviewing and addressing the needs of the authority's treasury management staff for training in investment management
- the authority's policies relating to the investment of any sums borrowed in advance.

THE LOCAL GOVERNMENT INVESTMENTS (SCOTLAND) REGULATIONS 2010

Local authorities in Scotland are required to prepare an annual investment strategy before the start of the financial year and an annual investment report after the financial year-end. This requirement reflects those in the CIPFA Treasury Management Code.

There is no intention to require authorities in Scotland to produce a separate investment strategy. An authority's net treasury position is determined by the relationship of the capital financing requirement (its need to borrow) and its balances and reserves (its potential to invest). As such, capital investment, borrowing and the investment of money are interrelated, and it is considered that local authorities should have an integrated strategy within which both its borrowing and its investments are considered. Scottish ministers recommend that authorities have a single strategy covering capital, treasury management, the setting of prudential indicators and the requirements of these investment regulations and consent.

A single report covering the same elements should be produced at the financial year-end. Local authorities should set out their strategy for investments, and explain their investment objectives and policies, including any special circumstances applying to them that have led to a particular approach. Stating the objectives of investments will identify those investments held for an investment return or for other service reasons. The report should seek to provide an objective evaluation of performance against the strategy. Where benchmarking has been undertaken, details should be included in the report.

SECTION 9

External service providers

Local authorities have extensive relationships with financial and money market practitioners in their banking, borrowing and capital/project financing activities, as well as in their cash investment functions. These include bankers, brokers, advisers, consultants, software providers, investment banks, credit rating agencies and fund managers. These relationships need to be managed proactively in order to secure the optimum benefit for an authority. They should be subjected to regular review and, in accordance with standing orders, to formal invitations to tender for services, if value for money is to be obtained.

It is essential that authorities are clear as to the services provided under contracts and that these are clearly documented. Particular attention should be paid to the question of potential conflicts of interest, and to establishing the degree of objectivity and independence which authorities are entitled to expect from advice given and transactions executed by external service providers.

It should be remembered that the responsibility for treasury management cannot be delegated outside the authority and that external service providers are supporting the authority's in-house treasury management function.

Authorities should be mindful of the requirements of the Bribery Act 2011 in their dealings with external providers.

Authorities should aim to share information and good practice between themselves. This can be achieved via established technical groups which already discuss treasury management, or via more formal groups such as CIPFA's Treasury Management Network.[13]

13. www.cipfanetworks.net/treasurymanagement

SECTION 10

Treasury management implications of the housing self-financing reform

BACKGROUND

The Prudential Code has a section that is specific to local authorities with housing functions. It requires such authorities to ensure that they:

- consider the impact on acceptable rent levels when considering the affordability of capital plans
- make separate calculations for their HRA and non-HRA elements and for the estimated impact on rents as well as council tax.

It also requires local authorities with housing functions to '*have regard*' to this section of these guidance notes and therefore to the treasury management implications of the housing self-finance reform for English authorities.

While there are no specific requirements for authorities with housing to calculate separate treasury management indicators for the General Fund and the HRA, such authorities may wish to consider the benefits of preparing local indicators in this area.

The abolition of the housing subsidy system in April 2012 will either require housing authorities to take on additional borrowing to buy themselves out of the subsidy system or give some authorities a lump sum. In addition, local authorities will need to allocate existing and future borrowing costs between housing and the General Fund as the current statutory method of apportioning debt charges between the General Fund and the HRA will cease.

This section sets out a methodology for splitting loans to meet the requirements of the new system. The Government has signalled its intention not to impose a single solution and authorities may pursue other methods provided that they achieve the principles detailed in their treasury management strategies approved by their full council.

While this section sets out the methodology for attributing loans to the HRA for accounting purposes, it should be remembered that the loans themselves remain a debt of the overall authority and the government will not be requiring the PWLB to separate loans at source. All loans are charged indifferently on all the revenues of the authority in accordance with the 2003 Act, and all loans have the benefit of the 'safe harbour' provision, which means that lenders do not need to enquire whether the authority has power to borrow the money and shall not be prejudiced by the absence of any such power.

It should also be remembered that the section 151 officer retains overall responsibility for treasury management in an authority, which includes debt management.

PRINCIPLES

The principles upon which the allocation of loans should be based are as follows:

- The underlying principle for the splitting of loans, at transition, must be that of no detriment to the General Fund.
- Local authorities are required to deliver a solution that is broadly equitable between the HRA and the General Fund.
- Future charges to the HRA in relation to borrowing are not influenced by General Fund decisions, giving a greater degree of independence, certainty and control.
- Uninvested balance sheet resources which allow borrowing to be below the CFR are properly identified between General Fund and HRA.

DEFINITIONS

There are a number of key definitions used throughout this section:

Capital Financing Requirement (CFR)	The capital financing requirement represents the authority's underlying indebtedness for capital purposes.
Subsidy Capital Financing Requirement (SCFR)	The amount of borrowing supported by the current subsidy system.
Settlement Net Present Value (NPV) Debt	The amount of borrowing that can be sustained under the DCLG self-financing model.
Settlement Figure (SF)	The difference between the positive SCFR and settlement NPV debt which will be payable to/receivable from the DCLG at settlement. Negative SCFRs are adjusted to zero for these purposes.
HRACFR (pre-settlement)	The HRA share of the authority's total CFR – this may be lower than the SCFR due to the application of capital receipts or revenue resources.
GFCFR	The General Fund (residual) share of the CFR.
HRACFR (post-settlement)	The housing CFR post-settlement.
Unfunded CFR	The amount of CFR that is not funded by loans or other long-term liabilities.
HRA Credit Arrangements CFR	The amount of HRACFR that relates to credit arrangements.
HRA Loans CFR	The amount of HRACFR that relates to loans.

DETERMINING THE QUANTUM AND COMPONENTS OF HRA DEBT

The HRACFR represents the HRA's credit arrangements plus its underlying requirement to borrow to finance capital expenditure. It is the HRACFR that is used as the measure for DCLG to determine an authority's compliance with its limit on indebtedness or the maximum underlying debt requirement. If an authority borrows in advance of need, this does not affect the level of indebtedness, which is determined by the level of HRACFR.

The HRACFR can be split between the 'HRA Credit arrangements CFR' and the 'HRA Loans CFR'. Gross HRA debt (including credit arrangements) is defined as the HRACFR plus any cash overdrawn, resulting from adverse cash flow movements and cash-related balances. A cash-in-hand position, resulting from positive cash flows and balances, produces an HRA loans receivable balance.

In attributing a share of actual loans outstanding to the HRA, it is expected that generally only long-term loans will be split. If the long-term loans attributed to the HRA are less than the HRA loans CFR, this is referred to as an 'under-funded loans CFR', and the shortfall should be treated as HRA short-term loans payable. If the HRA long-term loans exceed the HRACFR, this is referred to as an 'over-funded loans CFR', and the excess should be treated as HRA loans receivable.

In addition, the HRA may have cash-related balances resulting from debtors, creditors and reserves, which should be treated as creating a cash overdrawn or cash-in-hand position. This should also be treated as HRA short-term loans payable or receivable. Authorities are likely to find it impracticable to separately attribute short-term loans to the HRA, because of the high number and rapid turnover of such loans. It is likely therefore that they will continue to manage a single short-term loans portfolio, and apportion the costs on an appropriate basis. This is discussed further below.

The different components of HRA debt for treasury management purposes can accordingly be identified as follows:

a) **Credit arrangements**, eg concession agreements and finance leases: the liability value outstanding on the balance sheet should always equal the HRA credit arrangements CFR.

b) **Long-term loans payable**: these should be separately identified loans taken by the authority and attributed to the HRA.

c) **Short-term loans payable or receivable representing an under-funded or over-funded CFR**: as discussed above, it is likely that these short-term loans will not be separately identified to the HRA but will be managed in a combined HRA/General Fund portfolio.

d) **Short-term loans payable or receivable representing cash balances overdrawn or in hand**: the amount of cash balances will be estimated by the authority based on HRA balances and in-year cash flows, in a similar way to the 'revenue interest' calculation under the old statutory determinations. As with c) above, these are unlikely to be separately attributed to the HRA.

The relationship of these four elements can be illustrated by a simple example:

	Fully funded CFR	Under-funded CFR	Over-funded CFR	Fully funded CFR (cash balances in hand)	Fully funded CFR (cash balances overdrawn)
Alternatives:	**A**	**B**	**C**	**D**	**E**
HRA Credit Arrangements CFR:	10	10	10	10	10
HRA Loans CFR: long-term loans	90	70	105	90	90
HRA Loans CFR: short-term loans payable or receivable	0	20	-15	0	0
HRA Cash balances: short-term loans payable or receivable	0	0	0	-5	5
HRA Net Debt	**100**	**100**	**100**	**95**	**105**
The following figures can be produced from the above analysis:					
HRACFR	100	100	100	100	100
HRA Gross Loans Outstanding	90	90	105	90	95
HRA Gross Debt	100	100	115	100	105
HRA Loans Receivable	0	0	-15	-5	0

The alternatives above are as follows:

- Alternative A shows an authority that has chosen to fully fund its loans CFR with long-term loans.
- Alternative B shows an authority that has chosen to under-fund its CFR, ie it has not funded all its loans CFR with long-term loans but has left a balance of £20m represented by short-term loans. It prefers to have some short-term interest rate exposure.
- Alternative C shows an authority that has over-funded its loans CFR, ie it has more long-term loans than the loans CFR, resulting in a surplus represented by short-term loans receivable. This may be because it has actively decided to borrow in advance of requirement for the HRA.
- Alternatives D and E show variants of Alternative A for authorities that have cash balances in hand and overdrawn (respectively).

It is important that authorities assemble the whole picture of HRA debt above in order to make HRA treasury management decisions in the light of all the treasury exposures.

CIPFA's Treasury Management Code states that:

Where external funds are managed on behalf of a third party or pension fund, these funds should be separately identifiable and income and expenditure attributed in line with an agreed policy.

It is accepted that HRA funds are not third party funds but funds of the authority and so will not necessarily be separately identifiable. That said, local authorities should have a clearly agreed policy approved by full council for attributing income and expenditure and risks between the General Fund and the HRA.

ACCOUNTING FOR HRA LOANS

The capital financing requirement arises from capital expenditure to be financed from borrowing and so reflects the cash values of borrowing. Loans should therefore be split according to the nominal loan value. The charge to the HRA for HRA borrowing, as set out in the statutory determinations, should be made in line with proper accounting practice, eg taking into account effective interest rates, etc, as well as any statutory adjustments for the deferred write-off of premiums and discounts, etc. However, the separate calculation for unfunded HRACFR and cash overdrawn will need to be calculated by reference to nominal loans, rather than to the loans outstanding figure on the balance sheet, which is influenced by accounting adjustments.

UNDERSTANDING THE BASIS OF THE SETTLEMENT

This publication has been produced based on the following understanding of the settlement process:

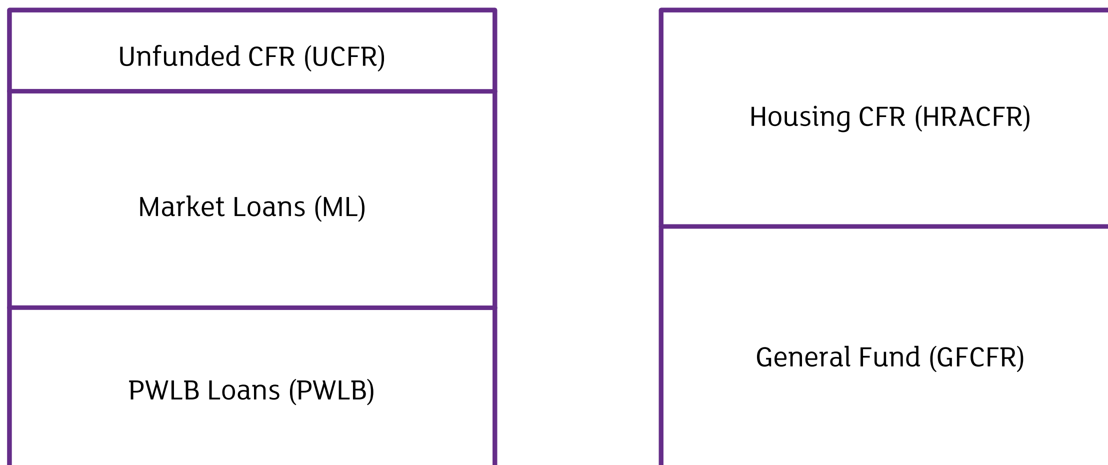
- The settlement NPV debt relates to the borrowing that the business plan can sustain after recognising the costs of other existing indebtedness such as leasing. Balance sheet premiums and discounts will be included in this calculation.
- The settlement figure is the transaction required between the DCLG and the local authority and is the difference between the settlement NPV debt and the SCFR. Where the SCFR is negative it is treated as nil for the purposes of the calculation.
- SCFR relates purely to borrowing and not to the wider elements of debt, such as other long-term liabilities.
- Where authorities are reducing debt, DCLG will make a payment to reduce the existing borrowing portfolio and cover any resultant premiums and discounts. PWLB loans will be repaid first.
- Where authorities are increasing debt to buy out of the subsidy system, the source of funding will not be prescribed by government.
- Any headroom between SCFR and HRACFR will be maintained as borrowing headroom under the debt cap.

PROPOSED SOLUTION: TWO LOANS POOLS (GENERAL FUND AND HRA)

Splitting existing loans

Currently the underlying debt requirement in local authorities may include credit arrangements, which will need to be deducted before the following analysis is undertaken. The residual CFR, referred to earlier as the loans CFR, may be funded through a mixture of PWLB loans and market loans and an element may remain unfunded.

The following diagram provides an example of an authority with all three elements satisfying the CFR for HRA and General Fund (again, this relates only to the borrowing requirement and not to any other long-term liabilities or credit arrangements within the CFR):



Unfunded CFR is matched by authorities' use of the cash from reserves, revenue balances and favourable cash flow to reduce the need to borrow up to the level of the CFR.

In the main, this available cash relates to General Fund reserves and balances and consequently the HRACFR is, where possible, fully borrowed. The exception is interest on HRA balances which is covered in the 'Unfunded/Over-funded HRACFR' section on page 38. Where material HRA balances exist they should be taken into account in a local authority's calculations, either as an adjustment to the split of loans or by separate treatment as resources available for investment.

Where sufficient loans exist (market or PWLB), the loans taken on by the HRA are calculated as follows:

Housing share of PWLB: PWLB (H) = HRACFR/total loans X PWLB loans

Housing share of market loans: ML (H) = HRACFR/total loans X market loans

Where insufficient loans exist (HRACFR > total loans), the balance is represented by unfunded CFR.

This is illustrated in the example below:

CFR Split	**£**	**Existing Position**	**£**
HRACFR	20,000,000	PWLB	28,000,000
GFCFR	24,000,000	ML	12,000,000
		UCFR	4,000,000
CFR	44,000,000	CFR	44,000,000

Housing

PWLB	20,000,000 / 40,000,000 x 28,000,000 =	14,000,000
ML	20,000,000 / 40,000,000 x 12,000,000 =	6,000,000
	HRACFR	20,000,000

Where the HRA takes on unfunded CFR, the choice is to take on additional borrowing to fully borrow up to the level of HRACFR or to retain unfunded CFR and pay interest to General Fund in line with the policy on interest on balances. This choice will need to be exercised on the basis of the authority's overall cash flows and treasury and investment policies and strategies.

In order to ensure equity, all types of loans should be split between the HRA and General Fund. It is recognised that this will have practical implications, but as the General Fund and the HRA are likely to have different optimum maturity profiles and restructuring requirements in order to manage their treasury management risks, it is likely to be the preferred long-term solution. Splitting loans may result in a minimal increase in administration but interest payments are already aggregated so there should be no additional transaction charges.

Where an authority decides to allocate a loan between the General Fund and the HRA, it may wish to ask the PWLB to physically split the loan rather than to maintain an internal apportionment. This will aid transparency and accountability. Where a loan has less than a year until maturity, it is unlikely that there will be a benefit in physically splitting the loan. The PWLB will not be separating debt on settlement of the housing self-financing transaction, but it would be open to authorities to approach the PWLB later.

Only market loans taken as long-term loans should be shared with the HRA. Generally, short-term loans should remain General Fund loans, and any short-term exposure of the HRA will be calculated via the interest on balances calculation (further discussed below). For market loans, it will not be possible to physically split the loans but instead they can be split notionally and separated when they are next restructured. This does mean that decisions on initial restructuring of these loans will need to be taken balancing the corporate needs of the HRA and the General Fund.

Where authorities can achieve a similar impact, including interest and maturity profiles, by allocation of complete individual loans between the two pools, then this may be an easier route for them to adopt.

Once loans are separated post-settlement, decisions may be required in terms of the rescheduling of loans for either the General Fund or the HRA. An authority may be in the position where one pool wishes to repay loans and another to take on new loans. If this is the case, an authority should consider whether it would represent overall value for money for the authority to transfer a loan at that point. For example, it may be that the cost of a higher rate of interest on an existing loan more than offsets the benefits of a reduced rate on a new loan when including the notional premium costs of repaying the existing loan.

Internal loans and investments between the HRA and the General Fund may also be appropriate, avoiding the credit risks of actual external investment. In such cases, authorities need to choose and evidence a fair rate of interest to charge.

AUTHORITIES WITH AN INCREASED DEBT REQUIREMENT AT SETTLEMENT

Where authorities make a payment to the government at the settlement date, this will be treated as capital expenditure, which will automatically increase the HRACFR. The authority can then take out additional borrowing up to the level of the HRACFR. The cash for the payment to the government will come from the loan.

CFR Split	£000	Existing Position	£000
HRACFR	137,000	PWLB	135,000
GFCFR	21,000	ML	7,000
		Short-term loans	2,000
		UCFR	14,000
CFR	**158,000**	**CFR**	**158,000**

Housing		
PWLB	137,000 / 142,000 x 135,000 =	130,246
ML	137,000 / 142,000 x 7,000 =	6,754
	HRACFR	137,000

		£000
Settlement Figure		32,000
Additional Borrowing (assume PWLB)		32,000
New Borrowing Figures		
	PWLB	162,246
	ML	6,754
HRACFR		169,000

AUTHORITIES WITH A REDUCED DEBT REQUIREMENT AT SETTLEMENT

Where authorities receive a settlement from the government this will be used to repay PWLB loans before any market loans. In order to ensure that loans can be repaid to the PWLB, it will be necessary to repay the PWLB loans before splitting the residual loans between the HRA and the General Fund. The repayment will reduce the HRACFR and hence reduce the amount to be apportioned to the HRA.

If an authority has borrowed in advance of need for a specific purpose, it would be appropriate for such loans to be excluded from the split.

CFR Split	£000	Existing Position	£
HRACFR	711,000	PWLB	609,000
GFCFR	382,000	ML	484,000
		UCFR	0
CFR	1,093,000	CFR	1,093,000

Debt Repayment

Settlement			-553,000
CFR Split	**£**	**Existing Position**	**£**
HRACFR	158,000	PWLB	56,000
GFCFR	382,000	ML	484,000
		UCFR	0
CFR	540,000	CFR	540,000

Housing

PWLB 158,000 / 540,000 x 56,000 =	16,385
ML 158,000 / 540,000 x 484,000 =	141,615
HRACFR	158,000

SPECIFIC SITUATIONS

Debt-free authorities

Several local authorities are known to be debt free. In strict terms they have a nil or negative debt requirement or CFR. In some instances, the General Fund CFR is positive and the HRACFR is negative, making the overall CFR negative or zero.

The examples below illustrate how the solution would work in debt-free authorities:

CFR	-13,000,000
Which includes	**£**
HRACFR	- 15,000,000
GFCFR	2,000,000

The negative CFR of £13m is supported by capital cash balances. £15m is HRA set aside capital receipts, of which £2m is used in lieu of borrowing for General Fund. Actual borrowing is zero.

Settlement

Settlement NPV debt	100,000,000
SCFR	-10,000,000
(Negative SCFR is treated as zero for calculation of the settlement figure)	
Settlement Figure (payment to DCLG)	100,000,000
Funded by:	
Cash balances	13,000,000
New GF borrowing	2,000,000
New HRA borrowing	85,000,000
	100,000,000

Post-settlement CFRs

Payment to DCLG	100,000,000
HRACFR (pre-settlement)	-15,000,000
HRACFR (post-settlement)	85,000,000
GFCFR	2,000,000
CFR	87,000,000

It should be noted that the flexibility offered by the current rules enables no Minimum Revenue Provision (MRP) to be made on the General Fund, as the overall CFR is negative. At settlement the CFR increases to become positive. The DCLG policy document *Self-financing: Planning the Transition*, published on 28 July 2011, sets out proposals to amend the guidance on MRP so that the self-financing settlement does not have any impact on the General Fund MRP.

Unfunded/over-funded HRACFR

It is likely that due to differences in timing between expenditure and loans being drawn down that the identified HRA loans will not always match the HRACFR. In this case, the unfunded or over-funded element will need to be taken into account in the interest on balances calculation. On the housing balance sheet the difference will show as either cash overdrawn or cash in hand with the analysis of the variation being reported as part of the treasury management reporting arrangements.

Where an authority undertakes borrowing that is short term in nature, this should be managed centrally as part of overall cash flow management. The HRA element will be carried as unfunded/over-funded CFR and any charge to the HRA calculated as part of interest on balances. This allows the HRA to determine its own short-term/long-term borrowing mix by choosing whether to fully fund the HRACFR from long-term loans.

Maturing HRA loans

Once the loans are split they remain totally separate. Therefore, when an HRA loan matures, it will need to be replaced by a new HRA loan, dependent on the borrowing requirement at the time and the treasury management position. If no new loan is taken out this may create an unfunded HRACFR position resulting in cash overdrawn to be dealt with through the interest on balances calculation.

Borrowing in advance of need

Where an authority, as a result of an identified need and in line with their treasury management strategy for the HRA, borrows in advance of need, this will create an over-funded HRACFR position which will result in cash in hand to be dealt with through the interest on balances calculation. Any permissible facility for borrowing in advance of need must be clearly stated in the treasury management strategy at the beginning of the year in accordance with the prudential framework.

Loan rescheduling after settlement date

Where PWLB has agreed to split loans into two to facilitate internal management, all rescheduling will be specific to HRA pool or General Fund pool. Where this has not happened, partial repayment of loans will enable independent management of the two pools.

For existing market loans, the initial rescheduling will have to be carried out balancing the needs of the General Fund and the HRA, which may be different. Future rescheduling will relate to loans that are already placed in one or the other pool.

As noted above, it may at times be mutually beneficial to move existing loans from the HRA to the General Fund portfolio or vice versa, recognising an appropriate 'internal' premium or discount. This avoids physically repaying and reborrowing, which would incur a significant loss on the repayment spread (particularly in the PWLB).

Transitional issues

Settlement will take place on 28 March 2012; however, CFR and debt figures will not be finalised until the accounts are closed. The suggested approach deals with the difference in timing:

- Budgets and treasury management strategies can be compiled based on estimates.
- New Borrowing from 1 April can be allocated to the new pools.
- Existing loans should be frozen at 1 April and apportioned as soon as final figures are known.

Where restructuring or replacement loans cannot be managed outside of this period, the replacement loan will need to be added to the pool of loans to be split once final figures are known.

ALTERNATIVE SOLUTIONS

Authorities may wish to use other principles to those stated on page 30, which must be approved by full council as part of their treasury management strategy. This may then lead them to alternative approaches as follows.

Three-pool approach

As an alternative to splitting existing loans, authorities may wish to pursue a three-pool approach. Under this approach the existing loan pool will become one residual pool, which will reduce in value as loans are repaid at maturity or earlier. Borrowing for new capital expenditure, including the settlement payment, additional loans to cover under-borrowing and replacement loans would then be allocated to the two new separate pools, one for housing and one for the General Fund.

While initially this approach may seem attractive as it avoids the need to split existing loans, authorities will need to consider the method of allocating the costs of servicing the loans in the residual pool and the impact of transactions moving forward.

One-pool approach

Local authorities may wish to continue with one pool and to apportion costs according lo locally established principles.

Whilst administratively this definitely has advantages, the impact on the consolidated rate of interest (CRI) of the settlement and the HRA business plan should not be underestimated. Authorities will need to give careful consideration to the impact of the CRI on the business plan and the impact of any future volatility in the CRI. Maintaining a one-pool approach may restrict the authority's ability to manage interest rates over time according to the HRA's loan and risk profile and to ensure that treasury management supports the business plan.

APPENDIX

Treasury management indicators and definitions

DEFINITIONS

These definitions shall be used for all purposes connected with the treasury management indicators, and in particular shall be used by the local authority in setting, revising and monitoring against their treasury management indicators.

It is intended that, throughout, the definitions used will be consistent with proper accounting practices for local authorities. Where changes to proper accounting practices significantly affect the prudential indicators, this fact should be highlighted by the local authority when setting or revising the indicators. If any figures in the authority's Statement of Accounts that are used in prudential indicators are subject to audit qualification, this fact should be highlighted when any prudential indicators are set or revised.

BORROWING

In the Prudential Code, borrowing refers to actual external borrowing. Prudential indicators for actual figures for previous years should be taken from the local authority's balance sheets for those years, by aggregating the amounts for:

- borrowing repayable with a period in excess of 12 months
- borrowing repayable on demand or within 12 months.

This value should then be adjusted to exclude any accounting adjustments made including premiums and discounts, transactions costs, accrued interest and Effective Interest Rate adjustments. The resulting value for borrowing should then be equal to the actual outstanding external borrowing at the end of the financial year.

Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

NB See also transferred debt below.

DEBT

For the purposes of the Prudential Code, debt refers to the sum of borrowing (see above) and other long-term liabilities (see below). It should be noted that the term 'borrowing' used within the 2003 Act and the 2011 Act requires credit arrangements for local authorities in England, Wales and Northern Ireland to be treated as the borrowing of money for the purposes of determining the

affordable borrowing limit and imposition of borrowing limits. In Scotland, credit arrangements are not treated as the borrowing of money but are recognised as an outstanding liability on the balance sheet and are considered to be a debt associated with capital finance. Within the Prudential Code, borrowing is distinguished from other long-term liabilities in order to relate the prudential indicators directly to the balance sheet.

Net debt is debt that is net of investments.

INVESTMENTS

Actual figures for investments for previous years should start with the sum of the amounts on the local authority's balance sheets for:

- long-term investments
- short-term investments
- cash and bank equivalents.

From this should be subtracted any investments that are held clearly and explicitly in the course of the provision, and for the purposes, of operational services.

This value should then be adjusted to exclude accrued interest, so that the resulting value is equal to the value of external investments including impairments.

Estimates for investments for current and future years should be calculated in a manner consistent with this definition.

NET BORROWING

For the purposes of the Prudential Code, net borrowing refers to borrowing (see above) net of investments (see above).

NB See also transferred debt (see below).

OTHER LONG-TERM LIABILITIES

'Other long-term liabilities' in this Code relates to the liabilities that are outstanding under credit arrangements (as defined by statute for England, Wales and Northern Ireland). The objective is to identify liabilities outstanding (other than borrowing) in relation to the financing of capital expenditure.

The definition of 'other long-term liabilities' starts with the sum of the amounts on the face of the local authority's balance sheet that are classified as liabilities which are for periods in excess of 12 months, other than borrowing repayable within a period in excess of 12 months, or liabilities that are for less than 12 months, for example during the last year of a PFI contract or finance lease. For clarification, amounts that relate to the Capital Adjustment Account, Financial Instruments Adjustment Account, Grants Unapplied, Unequal Pay Back Pay Account, Revaluation Reserve, Pensions Reserve, Capital Receipts Reserve, Available-for-Sale Financial Instruments Reserve, and Major Repairs Reserve (England and Wales – authorities with an HRA) are not included within the definition of other long-term liabilities for the purposes of the Prudential Code.

To the resultant figure must be added any amounts that are determined by legislation to be other long-term liabilities[14] that would otherwise not be so classified and from which must be subtracted any amounts that are determined by legislation not to be other long-term liabilities that would otherwise be so classified (referred to below as statutory adjustments). Deferred liabilities in respect of transferred debt should be treated in accordance with the definition below. Prudential indicators for previous years should be taken from the local authority's balance sheets as amended for any statutory adjustments. Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

TRANSFERRED DEBT

Some local authorities are managing debt that was transferred to them on reorganisation and which relates to a number of other organisations as well as themselves. While such arrangements continue, such local authorities (ie those managing the transferred debt/borrowing to on-lend) should include these amounts in their prudential indicators, except only that:

a) These amounts should be netted off when calculating net debt.

b) When considering financing costs, wherever possible financing costs arising from transferred debt should be excluded from the financing costs of the local authority that is managing the debt for other local authorities. This can be achieved by crediting income from the external organisation received in relation to the financing costs of the managed debt, in line with proper practices.

A local authority that is in the reverse of this position, ie for which another local authority holds debt managed in this way, should exclude these amounts from their prudential indicators, except only that:

c) When considering financing costs, wherever possible financing costs arising from transferred debt should be included within the financing costs of the local authority for which another local authority is managing its debt. This can be achieved by debiting amounts payable to the local authority managing the debt, in line with proper practice.

Borrowing undertaken in Scotland under section 1(d) of Schedule 3 to the Local Government Act (Scotland) 1975 should be treated in the same way as transferred debt.

14. Credit arrangements under Part 1 of the 2003 Act and the 2011 Act.

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