The Chartered Institute of Public Finance & Accountancy

Further Evidence:

To the Scottish Parliament Devolution (Further Powers) Committee on the Prudential Borrowing Framework

A Submission by:

The Chartered Institute of Public Finance and Accountancy

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CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

Further information about CIPFA can be obtained at www.cipfa.org

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1. Introduction

1.1 The purpose of this document is to provide further detail to the Scottish Devolution (Further Powers) Committee on the Prudential Borrowing Framework. This document will specifically focus on why there is a need for supporting legislation to put in place the framework, the principles and effective operation of the framework and lastly what governance and accountability arrangements should be in place.

2. The need for primary legislation

2.1 The current legislative position for the Scottish Government is that it has prescribed borrowing limits set out in the Scotland Act 2012. The Smith Commission proposed enhanced borrowing powers for Scotland[1] and that the Scottish and UK Government should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework. CIPFA supports this view and would advocate that UK primary legislation should reflect the following:

'It is the duty of the Scottish Government to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure'.

2.2 Such legislation could go on to state that in discharging that duty, the Scottish Government shall comply with regulations made by the Scottish Ministers. The supporting regulations may, in particular, make provision for:

(a) Prescribing when and in respect of what periods estimates and supporting indicators are to be made;

(b) Prescribing how those estimates and indicators are to be arrived at and any considerations to which regard is to be had in arriving at them;

(c) Prescribing how Scottish Government Bodies are to keep those estimates and indicators under review and any considerations to which they must have regard in doing so;

[1] The Smith Commission Report, paragraph 95(5) http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf

(d) Requiring Scottish Government Bodies to make to the Scottish Ministers such reports containing such information as is prescribed by the regulations;

(e) Requiring the amounts determined above and the factors on which the estimates and indicators are based to be subjected to such process of audit as is prescribed by the regulations;

(f) Requiring information about those amounts and those factors to be published,

2.3 The considerations referred to in paragraphs (b) and (c) above may include codes of practice referred to in the regulations. The current regulations in local government[3] refer to the use of the CIPFA Prudential Code.

2.4 CIPFA would contend that the need for such a legislative framework to support borrowing powers for the Scottish Government arises from the following:

(a) Legislation supporting a prudential approach allows the Scottish Government flexibility in determining overall borrowing levels subject to the agreed Scottish Fiscal Framework. This would potentially enable more effective interventions to support the economy in Scotland as required, rather than being restricted to set limits as in the current legislation under the Scotland Act 2012.

(b) Legislation of this nature fully supports the recommendations put forward by the Smith Commission[2] and also supports a robust set of institutional arrangements and controls that are designed to ensure financial sustainability in public finances.

(c) The prudential system, underpinned by legislation and regulation, provides a self-regulatory framework that extends into all areas of central government, subject to retention of reserve powers by the Scottish Executive.

(d) An important aspect of the self-regulatory environment created by the prudential system is that it closely links with capital and asset management planning and therefore supports more effective value for money decision making on capital investment.

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[2] The Smith Commission Report, paragraph 95

3. Principles and the Operation of the Prudential Framework

3.1 The main principles behind the prudential framework are the affordability, sustainability and prudence of borrowing decisions. The framework supports improved strategic and asset management planning and we believe will underpin a Scottish fiscal framework in line with the overall UK fiscal framework.

(a) Affordability

The fundamental objective of affordability is to ensure that capital plans remain within sustainable limits and in particular, to consider its impact on revenue resources and therefore taxation. Setting affordable limits for borrowing within a prudential framework is a specific requirement and helps ensure that the further objectives of sustainability and prudence are addressed.

(b) Sustainability

The sustainability of public finances underpins the overall UK fiscal framework and is supported by the prudential code. Sustainability of public finances relates to the ability of a government to sustain its current spending, tax and other policies in the long run without threatening government solvency or defaulting on of its liabilities or promised expenditures.

(c) Prudence

The prudent level of borrowing is linked to ensuring that debt will only be for a capital purpose. It is also prudent that treasury management activities are carried out in accordance with good professional practice. Within the CIPFA Prudential Code, local authorities are required to adopt the CIPFA Treasury Management Code of Practice[3].

3.2 The borrowing levels within the prudential framework are linked to their implications on affordability within the revenue budgets rather than capital budgets. This means that the impact on running costs is the driver of affordability rather than the level of capital budgets available. This also helps underpin the longer-term inter-generational affordability and

[3] CIPFA's Treasury Management in the Public Services: Code of Practice and cross sectorial guidance notes 2011

prudence of capital investment plans. This approach is inconsistent with a prescribed limit of £2.2bn as contained in the Scotland Act 2012.

3.3 In summary, the operation of this framework will require the Scottish and UK Governments to consider:

i) Enabling legislation and supporting regulations governing the framework.

ii) Effective Corporate Governance arrangements. This will include identification of the relevant and appropriate government body that will oversee and approve the operation of the Prudential Framework. This would include approval of a set of agreed Prudential Indicators.

iii) Clearly defined roles and responsibilities for the Chief Financial Officers of all government bodies covered by the legislative arrangements. Particularly, this role will involve responsibility for ensuring that matters to be taken into account when setting and revising prudential indicators are reported to the relevant decision making body for consideration. Preparing and presenting the Prudential Indicators for agreement and also, reporting regularly on the robustness of the estimates used in this regard.

3.4 The operation and approval of the framework should coincide with the approval of budgets and should happen prior to the start of the financial year. There should also be in place a process for regular monitoring of the supporting indicators during the financial year. **Appendix A** provides an outline set of prudential indicators as used in Local Government.

3.5 Alongside the prudential framework there needs to be a comprehensive Treasury Management and Borrowing strategy. This will ensure that the principles of security and liquidity of funds is secured and that yield from investments is considered but not at the expense of security and liquidity.

An important point to observe in this framework is that borrowing is not linked to asset purchases, i.e. the Scottish Government should not be borrowing for specific assets, but for its need to finance capital requirements. This means that should the Scottish Government have freely available funds in reserves, it may decide to utilise those funds in the short-term rather than borrow at an increased cost.

3.6 Adopting this approach may also necessitate that the charge made to revenue budget for the cost of borrowing reflects the Government borrowing need and not its actual loan debt. How and when they actually borrow the funds is a matter for their Treasury Management strategy.

Approval, alongside the Prudential Indicators, would be required for the Treasury Management Strategy and Policy and any Minimum Revenue Provision made against budgets.

4. Accountability and Governance

4.1 The adoption of a Prudential Framework for borrowing in Scotland would signify a move towards a more self-regulated process and away from fixed limits on borrowing. As a result the accountability and governance arrangements need to be robust and effective for the system to be successful. A successful system will demonstrate to external funders that the appropriate control systems and processes are in place and that the Scottish Government can demonstrate a prudent and affordable approach to its borrowing.

4.2 The Prudential Indicators and the approval of them, form an important element of the accountability and governance process. The approval requirements arise from the necessity that decisions about borrowing and its affordability are matters of political judgement, which must be made by those charged with governance, such as elected members of the Scottish Government. In doing this they are supported by the framework supplied by the Prudential Code and by the advice of their Chief Financial Officers.

4.3 CIPFA also sees a vital role here for the new Scottish Fiscal Commission in acting as an independent advisor to the executive on the issues for affordability and prudence of the proposed borrowing levels.

As outlined in the previous section, there will be clear roles for those charged with governance, the Scottish Government, those charged with oversight and advice, such as the Scottish Fiscal Commission and those charged with preparation and production of estimates and indicators, i.e. the Chief Financial Officer role.

Appendix A. – Example Prudential Indicators

1. Indicators for External Debt

1.1 Operational Boundary

The Authority will set for the forthcoming financial year and the following two financial years an operational boundary for its total external debt, excluding investments and separately identifying borrowing from other long-term liabilities (such as finance leasing arrangements). The operational boundary will provide in year monitoring and is set lower than the authorised limit (see below) as it is based on an estimate of the most likely level of external borrowing at any point during each year.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Operational Boundary					

The Operational Boundary represents the maximum level of external debt projected (most likely prudent view)

1.2 Authorised Limit

The Authority will set for the forthcoming financial year and the following two years an authorised limit for its total external debt, excluding investments and separately identifying borrowing from other long-term liabilities. The authorised limit will contain sufficient headroom to provide for any unanticipated payments as well as being based on the authorities' capital investment plans.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Authorised Limit					

The Authorised Limit will provide for the authorities statutory obligation to set an affordable limit on debt.

1.3 Actual External Debt

The Prudential Indicator for actual external debt is considered at a single point in time and hence is only comparable to the authorised limit and operational boundary at that point in time. This figure may also indicate the split of debt into fixed rate and variable rate borrowing and some indication of average rates for debt and average borrowing periods.

2. Capital Expenditure Indicators

2.1 Capital Expenditure

The Authority will make reasonable estimates of the total capital expenditure that it plans to incur during the forthcoming financial year and following two years. The estimates of capital spend will include any estimated spend (dependant on option appraisals) or spend dealt with as other long-term liabilities, i.e. leasing and PFI/PPP arrangements.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Capital Expenditure					

2.2 The Capital Financing Requirement

The Authority will make reasonable estimates of the total capital financing requirement at the end of the forthcoming financial year and following two years. The capital financing requirement will represent the authorities' underlying need to borrow.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Capital Financing Requirement					

Essentially this figure is the total capital value held, less any associated revaluation reserves less any amount previously charged to the general fund for capital financing, i.e. what value is left to fully finance the asset base.

3. Indicators of Affordability

3.1 Ratio of Financing Costs to Net Revenue Stream

This indicator provides a measure of the proportion of the net revenue budget that is being allocated to the financing of capital expenditure. The authority will estimate this measure for the forthcoming financial year and the following two years.

%	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Ratio of Financing Costs to Net Revenue Stream					

This indicator demonstrates the incremental impacts of planned capital spend and associated borrowing on the level of local taxation.

4. Prudence Indicators

4.1 Gross Borrowing and the Capital Financing Requirement

The Authority should ensure that gross external borrowing does not, except in the short term, exceed the total of the Capital Financing Requirement in the preceding year plus any estimates of additional capital financing requirement for the current, the forthcoming and the following two years.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Capital Financing Requirement					
Gross Borrowing					

Under/(Over)					

5. Treasury Management and External Debt Indicators

There are four treasury prudential indicators, the purpose of which is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce financing costs. The indicators are:

5.1 Compliance with the CIPFA Code of Practice for Treasury Management in the Public Services

This is an adoption statement aimed at ensuring that treasury management is led by a clear and integrated forward treasury management strategy, and recognition of the pre-existing structure of the authorities borrowing and investments portfolio.

5.2 Interest Rate Exposures

The authority will set upper limits on variable and fixed rate exposures. This identifies the maximum limit for variable or fixed rates based upon the debt position.

%	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Limits on fixed interest rates on debt					
Limits on variable interest rates on debt					

5.3 Maturity Structure of Borrowing

This indicator sets limits to reduce the authorities' exposure to large fixed rate sums falling due to re-financing within the same financial year, and is required for upper and lower limits

%	Current Year		Year + 1	
	Upper	Lower	Upper	Lower
Under 12 months				
12 months to 2 years				
2 years to 5 years				
5 years to 10 years				
10 years and above				

5.4 Total Principal Sums Invested for Periods Longer than 364 Days

This sets out the authorities' position in relation to its ability to invest sums for period longer than 364 days and relates directly to liquidity of funds.

£m	Prior Year	Current Year	Year + 1	Year + 2	Year + 3
Principal sums invested > 364 days					