1. INTRODUCTION

1.1 CIPFA has been examining the financial provisions within the Scotland Bill. As a significant level of attention has already been given to the income tax proposals within the Bill by others, we have focused exclusively upon the proposed borrowing powers contained within Part 3, Paragraph 32 of the Bill. We are providing our preliminary views to the Scotland Bill Committee and we intend to submit further evidence in due course with particular focus on financial reporting and financial decision-making.

1.2 Given that local government in Scotland has borrowing powers and has a control framework in place, we have elected to compare and contrast the practice of local government borrowing with the proposals contained within the Scotland Bill. The themes for this comparison are:

- the form of debt and sources of borrowing;
- the volume of borrowing;
- the revenue financial consequences of the borrowing;
- the governance and control framework necessary to exercise effective scrutiny and control; and
- Treasury management professional practice and competence.

Following the comparison, each Section concludes with our recommendations.
2. FORM OF DEBT & SOURCES OF BORROWING

Local Government

2.1 Access to debt products by local authorities is expressly provided for in statute. Local authorities can raise money through borrowing by:

- Mortgage;
- Bank overdraft;
- Issue of stocks and bonds;
- Issue of bills; and
- Public works loans board.

2.2 There is also provision for Scottish Ministers to further regulate on each of the debt products and ‘..any other means…with the consent of the treasury.’

2.3 The consequence of previous case law is that local authorities cannot access higher risk debt products such as interest rate swap products and derivatives.

2.4 In both Scotland and England, local authorities have express powers to issue bonds. This has been out of favour in recent years because of issuance costs and available rates. The scale of issuance of any bond has implications for issue costs. Currently it is considered that any issuance of less than approximately £150M - £200M in bond value is too costly to merit that form of financing.

2.5 More recently, there has been interest in bonds as an alternative form of financing. This has arisen principally because of an increase in PWLB rates and in England & Wales from revision to housing revenue account financing.

2.6 Recent examples of large capital projects which have been financed by bond issue are Birmingham City Council, Transport for London and in Scotland, a small bond issue was undertaken by North Lanarkshire Council.

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1 Local Government (Scotland) Act 1975, Schedule 3, Section 2, (1)
2 Local Government (Scotland) Act 1975, Schedule 3, Section 2, (1) (g)
3 Hazell v Hammersmith & Fulham 1991
4 Local Government (Scotland) Act 1975, Schedule 3, Section 2, (1) (d)
5 Public Works Loan Board 1% increase over value of gilts
2.7 The main source of local authority borrowing however continues to be from the PWLB\textsuperscript{6}. This is demonstrated in the table below:

| Table 1: External Borrowing at 31 March 2010 by Scottish Local Authorities |
|---------------------------------|------------------|
|                                 | £ billion        |
| PWLB                            | 6.9              |
| Banks, Building Societies, Monetary Sector | 2.3            |
| Other including bonds           | 0.1              |
| **Total**                       | **9.3**          |

The Scotland Bill

2.8 At present, Scottish Ministers have very limited borrowing powers, essentially confined to short term borrowing as follows\textsuperscript{7}:

‘... to cover a temporary excess of sums paid out of the Scottish Consolidated Funds over sums paid into that fund ...or for providing a working balance ..’

2.9 The new subsection [5] to be inserted in to Clause 66 of the Scotland Act does allow the Secretary of State, (with Treasury approval), to vary the mode of borrowing available to Scottish Ministers and the Notes suggest that this may at some future point allow the possibility of the issuance of bonds and other instruments.

2.10 The Bill\textsuperscript{8} anticipates that borrowing could be from the National Loans Fund (NLF) and also from commercial lenders. It appears unlikely that in terms of debt servicing that commercial products would ever be more attractive than the former.

2.11 Access to the NLF provides a more privileged, higher status and cheaper form of loan than is available to local authorities, the NI Executive and the other bodies which are channelled into the PWLB as their public lender.

2.12 At the moment the Bill does not set any restrictions on the types of debt product which can be accessed from commercial lenders.

2.13 We recommend that:

\textsuperscript{6} CIPFA Capital Expenditure & Treasury Management Statistics 2009/10
\textsuperscript{7} HoC, 2010:36
\textsuperscript{8} Strengthening Scotland’s Future, HM Government 2010
Consideration must be given to the appropriateness of the Scottish Government being able to potentially access higher risk debt products via commercial lenders and whether restrictions should be considered.

3. VOLUME OF DEBT

Local Government

3.1 Under the previous local government control framework there was a limit placed by Scottish Ministers on the level of capital expenditure which could be incurred. This in practice was a proxy for a limit on the level of borrowing. Following the Local Government in Scotland Act 2003, the introduction of the prudential framework removed the limit on capital expenditure. The volume of debt undertaken is now a local decision and responsibility rather than central decision and responsibility. There is, within the Local Government in Scotland Act 2003, a reserve power to enable Scottish Ministers to introduce a national borrowing limit. HM Treasury has required a protocol to be developed on the arrangements to be introduced should a borrowing limit be implemented.

3.2 The table below shows the level of borrowing undertaken by local government following the introduction of the prudential framework. In the first three years there was no significant change in the level of borrowing although capital receipts were buoyant during this period. When capital receipts declined in 2008 an increase in borrowing can be seen. The table also demonstrates the ratio of borrowings incurred by local government compared to total revenue income. The range is from 4.1% to 10%. (note: This excludes any debt associated with PFI/PPP schemes)

<table>
<thead>
<tr>
<th>Table 2</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Revenue Income (TRI)</strong></td>
<td>16292</td>
<td>17094</td>
<td>17961</td>
<td>18260</td>
<td>18988</td>
</tr>
<tr>
<td><strong>Borrowings</strong></td>
<td>663</td>
<td>766</td>
<td>715</td>
<td>1207</td>
<td>1915</td>
</tr>
<tr>
<td><strong>Ratio Borrowing/TRI</strong></td>
<td>4.1%</td>
<td>4.5%</td>
<td>3.9%</td>
<td>6.6%</td>
<td>10%</td>
</tr>
<tr>
<td><strong>ScGovt grants</strong></td>
<td>446</td>
<td>553</td>
<td>722</td>
<td>767</td>
<td>891</td>
</tr>
<tr>
<td><strong>Capital receipts</strong></td>
<td>313</td>
<td>454</td>
<td>440</td>
<td>244</td>
<td>193</td>
</tr>
<tr>
<td><strong>Capital from Revenue</strong></td>
<td>246</td>
<td>199</td>
<td>173</td>
<td>196</td>
<td>166</td>
</tr>
</tbody>
</table>

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9 Local Government (Scotland) Act 1973 S.94  
10 Section 37, Local Government in Scotland Act 2003
3.3 At March 2010, overall outstanding Scottish local authority long term debt was of the order of £9.3 billion.\textsuperscript{11}

3.4 The Prudential Code prescribes that, in making its capital investment decisions, the authority must have explicit regard to option appraisal, asset management planning, strategic planning for the authority and achievability of the forward plan. Simplistically, asset management planning considers future service delivery need. That need then influences investment decisions which drives the need for borrowing. This can be contrasted with the practice under the previous control framework where the financial cap, rather than service need, dictated investment.

**The Scotland Bill**

3.5 Scottish Ministers will be allowed to borrow up to 10\% of the Scottish capital budget, approximately £230M with a restriction placed upon the overall stock of borrowing at £2.2 billion\textsuperscript{12}.

3.6 In the spirit of affordability, the parameters for local authority borrowing levels are based upon relationship to revenue income rather than capital budget.

3.7 For UK central government, during the period 1993-2003 (two different governments; a recession/boom and tight central expenditure controls), the proportion of UK whole of government revenues committed to interest payments climbed up from 6\% to almost 10\%. More recently, the proportion reduced to under 5\%.

3.8 On a wider timeframe, in 1978-9, Whole of Government Returns showed gross interest payments of 10\% of revenues. The budgeted gross interest figures represented 6\% of revenues in 2010-11. These sets of figures, included borrowing for both capital investment and revenue variations. They also show the costs of a portfolio of debt built up over a lengthy and sustained period of time. Any comparison must of course recognise that the Scottish Government would be starting afresh.

3.9 The prudential code prescription that investment decisions (and therefore borrowing decisions) must have explicit regard to asset management is not evident in the Bill.

3.10 **We recommend that:**

- The control framework in place should drive asset management planning and that any plans for borrowing presented to Parliament should be accompanied by a transparent and robust asset management plan.

\textsuperscript{11} CIPFA Capital Expenditure & Treasury Management Statistics 2009/10

\textsuperscript{12} Strengthening Scotland’s Future, HM government 2010.
4. REVENUE FINANCIAL CONSEQUENCES OF BORROWING

Local Government

4.1 The ability of local government to fund the revenue consequences arising from lending comes principally from block grant paid by the Scottish Government and from the power to raise local taxation in the form of council tax.

4.2 The consequences of capital expenditure funded by borrowing are the repayment of the borrowing itself and the repayment interest.

4.3 Local Government statute dictates that liabilities from external borrowing have ‘first call’ on revenues, before any other type of expenditure.

The Scotland Bill

4.4 We have undertaken preliminary calculations, which are designed to demonstrate the principles of borrowing and the consequences upon the Scottish Government budget of debt. We estimate that in the first year of the Act, funds of approximately £230M will be available for the relatively low cost (interest only) of £7.9M. By year eleven, the first year of debt repayment, the charge to the Scottish Government budget would increase to approximately £306M\textsuperscript{13}.

4.5 The previous Scotland Bill Committee recommended that borrowing powers within the Scotland Bill should be increased to £5B\textsuperscript{14}. We estimate that achieving that borrowing level over say, a thirty year period would incur interest charges of in excess of £3B.

4.6 The decision to undertake capital expenditure and subsequently pay interest and to repay external debt will represent a significant opportunity cost for the Scottish Government. Clearly, this will come at the expense of service block revenue expenditure. In terms of scale, the charge to the Scottish budget in year eleven could be broadly equivalent to the current level of annual expenditure on concessionary fares and bus services.\textsuperscript{15}

4.7 We have also modelled an alternative form of debt funding. The key principle in each case is that in the early years of the borrowing powers there is a risk that because of the profile of cash flows, the perception to decision-makers could be that there is the availability of additional funds when in fact it is a rescheduling of funding.

4.8 Unlike the clarity with the local government legislation, the bill is not clear which income source the borrowing by the Scottish Government will be secured upon.

\textsuperscript{13} Appendix, Table 1
\textsuperscript{14} The Scotland Bill Committee, 2011, Session 3
\textsuperscript{15} The Scottish Government Budget 2010/11
4.9 We recommend that:

- A sufficient degree of Parliamentary time is applied to the annual scrutiny of government’s borrowing plans, with a particular consideration of the long term impact of the borrowing on future revenue budgets;

- Consideration is given to the profile of debt charges that relate to any specific debt product; and that

- the relative priority of debt repayment is clarified.

5. GOVERNANCE AND CONTROL FRAMEWORK NECESSARY TO EXERCISE EFFECTIVE SCRUTINY AND CONTROL

Local Government

5.1 The borrowing and subsequent capital expenditure is controlled by a framework generally referred to as the prudential framework.

5.2 The framework encompasses primary legislation. Underlying regulation in the form of a statutory instrument, a professional code of practice – CIPFA’s Prudential Code for Capital finance in Local Authorities\(^\text{16}\) and the requirement for elected members to approve capital expenditure plans and associated borrowing and investment decisions.

5.3 The objectives of the Prudential Code are to ensure, within a clear framework, that:

- capital expenditure plans are affordable,

- external borrowing and other long term liabilities are within prudent and sustainable levels, and that

- treasury management decisions are taken in accordance with good professional practice.

5.4 To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out the indicators that must be used, and the factors that must be taken into account.

5.5 The prudential indicators are in the public domain. They require to be approved by elected members as part of the plans for capital expenditure.

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\(^{16}\) The Prudential Code for Capital Finance in Local Authorities
5.6 The Code places particular responsibility upon the statutory finance officer. The Code states that

“The chief finance officer is responsible for ensuring that matters required to be taken into account when setting or revising prudential indicators are reported to the decision-making body for consideration.”

5.7 The Code further requires that the statutory finance officer bring to the attention of the council matters which may result in the borrowing limit being breached by prescribing that:

“...where the chief finance officer forms the view that a limit is likely to be breached a report to the decision-making body is required...”

5.8 In practice the code is supported by a suite of prescribed prudential indicators which are designed to allow the council to test the affordability and sustainability of the proposed debt and to be assured that treasury management decisions are in accordance with good practice.

**Tests of Affordability**

5.9 The fundamental objective of affordability is to ensure that capital investment remains within sustainable limits and to consider the impact upon the budget and on local tax. Indicators of affordability include

- Ratio of financing costs to net revenue stream
- Authorised limit for external debt
- Operational boundary for external debt
- Actual external debt

**Tests of Transparency and Accountability**

5.10 It is essential that scrutiny should not be focused on borrowing itself. Borrowing is intended to fund capital expenditure and it is therefore essential that the need for borrowing is underpinned by a clear asset management strategy. That is to say that the primary driver for entering into a loan arrangement should be the clear need to support public service delivery. That transparency would come in the form of a transparent asset management strategy.

**The Scotland Bill**

5.11 The magnitude of the eventual Scottish Government debt portfolio, if full borrowing powers are exercised, will be substantial at £2.2 billion.
5.12 In submitting our evidence\textsuperscript{17} to the Commission on Scottish Devolution (the Calman Commission) we recommended that a robust control mechanism was necessary to ensure effective Parliamentary scrutiny.

5.13 The absence of a control framework is an omission which requires further development prior to enactment. Without a prescribed control framework, scrutiny and control of borrowing and capital expenditure by the Scottish Parliament will be less effective.

5.14 We recommend that:

- A Governance and control framework, which clearly sets out the responsibilities of the Scottish Government and the Scottish Parliament, is developed. The framework can be based on CIPFA’s Prudential Code for Capital Finance in Local Authorities\textsuperscript{18}; and

- There is an explicit requirement for the parliament to approve a set of prudential indicators annually and that the timing of this is aligned to the timetable for the annual budget bill.

6. TREASURY MANAGEMENT PROFESSIONAL PRACTICE AND COMPETENCE

Local Government

6.1 Local authorities are required to demonstrate that the CIPFA Treasury Management in the Public Services Code of Practice\textsuperscript{18} has been adopted. The aim is to ensure that professional treasury management practices are led by a clear and integrated forward treasury management strategy.

6.2 The Code specifically sets out the treasury management skill requirements such as knowledge of money and capital markets, awareness of available sources of funds and investment opportunities, ability to assess and control risk and an appreciation of the implications of legal and regulatory requirements. CIPFA also states that every public service organisation should assess the competence of staff involved in treasury management and to secure the necessary training.

6.3 Treasury management is a recognised professional discipline and is demonstrable by qualification – the CIPFA Certificate in International Treasury Management. This discipline is central to effective capital investment within the local authority sector.

The Scotland Bill

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\textsuperscript{17} Submission by CIPFA to the Commission on Scottish Devolution 2008.

\textsuperscript{18} CIPFA Treasury Management Code of Practice
6.4 The Bill does not prescribe any control framework in the form of the prudential code nor require that there should be adherence to a Treasury Management code.

6.5 We are aware that Scottish Government officials, led by the Finance Directorate, are currently reviewing the holistic implications of borrowing powers being developed, and actively considering options for staffing resources. This recognises that there has been no historic requirement for treasury management expertise.

6.6 One option worthy of exploration, is whether the Scottish Government could enter a shared service arrangement with local authorities to access the treasury management expertise which currently exists within local government. Treasury managers in local authorities currently manage a debt portfolio in excess of £9B compared to the £2.2B prescribed by the Bill. A shared arrangement would obviate any need to develop new and costly treasury infrastructure.

6.7 We recommend that:

- A treasury management framework based on professional treasury management discipline is introduced.
- If treasury management advice is developed in-house by the Scottish Government, that Parliament seeks assurance that the appropriate level of skills that are required have been developed.
- Sharing treasury management services with local government be explored.
APPENDIX 1

Table 3: Maturity Repayment Based on £2.2B Debt Limit

<table>
<thead>
<tr>
<th>Year</th>
<th>Level of Debt £</th>
<th>Estimated Charge to the Scottish Budget £</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year one</td>
<td>230,000,000</td>
<td>7,935,000</td>
</tr>
<tr>
<td>Year five</td>
<td>1,150,000,000</td>
<td>39,675,000</td>
</tr>
<tr>
<td>Year ten</td>
<td>2,200,000,000</td>
<td>75,900,000</td>
</tr>
<tr>
<td>Year eleven</td>
<td>2,200,000,000</td>
<td>305,900,000</td>
</tr>
<tr>
<td>Year twenty</td>
<td>2,200,000,000</td>
<td>205,900,000</td>
</tr>
</tbody>
</table>

Table 4: Annuity Repayment Based on £2.2B Debt Limit

<table>
<thead>
<tr>
<th>Year</th>
<th>Level of Debt £</th>
<th>Estimated Charge to the Scottish Budget £</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year one</td>
<td>230,000,000</td>
<td>26,953,000</td>
</tr>
<tr>
<td>Year five</td>
<td>711,240,000</td>
<td>132,964,000</td>
</tr>
<tr>
<td>Year ten</td>
<td>1,086,045,000</td>
<td>265,928,000</td>
</tr>
<tr>
<td>Year eleven</td>
<td>1,086,045,000</td>
<td>265,928,000</td>
</tr>
<tr>
<td>Year twenty</td>
<td>1,086,045,000</td>
<td>265,928,000</td>
</tr>
</tbody>
</table>

Table 5: Maturity Repayment Based on £5B Debt Limit

<table>
<thead>
<tr>
<th>Year</th>
<th>Level of Debt £</th>
<th>Estimated Charge to the Scottish Budget £</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year one</td>
<td>230,000,000</td>
<td>7,935,000</td>
</tr>
<tr>
<td>Year five</td>
<td>1,221,101,236</td>
<td>42,127,993</td>
</tr>
<tr>
<td>Year ten</td>
<td>2,636,692,242</td>
<td>90,965,882</td>
</tr>
<tr>
<td>Year twenty</td>
<td>3,543,493,891</td>
<td>422,349,322</td>
</tr>
<tr>
<td>Year thirty</td>
<td>5,000,000,000</td>
<td>575,806,392</td>
</tr>
</tbody>
</table>

Note
For the purposes of calculations we have assumed that the most likely borrowing option would likely be in the form of a NLF loan through the UK Debt Management Office (UKDMO).

Chartered Institute of Public Finance and Accountancy
15 September 2011