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An informal commentary by DCLG on The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2012 [Statutory Instrument 2012 No. 265]

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Department for Communities and Local Government

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CHANGES TO THE CAPITAL FINANCE SYSTEM

An informal commentary by DCLG on The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2012 [Statutory Instrument 2012 No. 265]

This is a purely informal commentary and not an authoritative interpretation of the law. Authorities are recommended to take their own legal advice on the meaning of the Regulations.

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1. INTRODUCTION

Capital Finance Regulations

1.1 This informal commentary explains the policy aims of amendments made by the *Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2012 [Statutory Instrument 2012 No. 265]*:
http://www.legislation.gov.uk/uksi/2012/265/contents/made

1.2 The main effects are to: bring **securitisation** within the capital finance framework, relax the rules on **bond investments**, and clarify the definition of **capital expenditure**. Some superseded cross-references are also updated.

1.3 The regulations amend the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003, SI 2003/3146* ("the 2003 Regulations") http://www.legislation.gov.uk/uksi/2003/3146/contents/made, as already amended by:

SI 2004/534 http://www.legislation.gov.uk/uksi/2004/534/contents/made
SI 2004/3055 http://www.legislation.gov.uk/uksi/2004/3055/contents/made
SI 2006/521 http://www.legislation.gov.uk/uksi/2006/521/contents/made
SI 2007/573 http://www.legislation.gov.uk/uksi/2007/573/contents/made
SI 2008/414 http://www.legislation.gov.uk/uksi/2008/414/contents/made

SI 2009/321 http://www.legislation.gov.uk/uksi/2009/321/contents/made
SI 2009/2272 http://www.legislation.gov.uk/uksi/2009/2272/contents/made
SI 2010/454 http://www.legislation.gov.uk/uksi/2010/454/contents/made

1.4 All of the above regulations are made under the *Local Government Act 2003* ("the 2003 Act"): http://www.legislation.gov.uk/ukpga/2003/26/contents.

1.5 The main changes come into force on **1 April 2012** and thus apply with effect from the financial year 2012/13. Others come into force on **31 March 2012** and so apply with effect from 2011/12 (see paragraphs 3.6 and 5.1).

Minimum Revenue Provision Guidance

1.6 This commentary also sets out (paragraph 6.1) the changes being made to the DCLG guidance on ***Minimum Revenue Provision (MRP)***, which come into effect at the same time as the amendment regulations and are intended to assist those authorities taking on new debt as part of the Housing Revenue Account reforms.

2. SECURITISATION [Amendment Regulations 3(c), 4(1), 4(3), 6]

2.1 "Securitisation" as used in this context means the disposal of future revenues. For example, a landlord receiving rents from properties might transfer the entitlement to that income to a bank for (e.g.) 20 years, in exchange for an immediate lump-sum payment. From a technical accounting viewpoint, securitisation appears to be the *sale* of an asset (the future revenue stream) and the lump-sum received is the sale proceeds, not borrowed money. But the strategy achieves the same result as borrowing and might be seen as an alternative to it.

2.2 Whether any such securitisation transaction would be lawful is a matter for individual authorities to consider, taking account of the precise nature of the contract and of their statutory powers. Authorities and their legal advisers will be aware that section 13 of the 2003 Act (security for loans) does not explicitly mention securitisation; and that section 1 of the *Localism Act 2011* (general power of competence), giving authorities the powers of an individual person, is subject to limitations imposed by law. The amendments described below do not imply that Government's view is that securitisation is lawful. Ultimately, only the courts can determine whether or not a particular transaction is lawful.

2.3 However, the possible use of securitisation by local authorities gives rise to concerns which the amendment regulations seek to address. The overall effect is that the amendments do not in themselves prevent securitisation, but ensure that, if it is used, it will be on an equal footing with borrowing and other forms of credit. There will be no perverse incentives for authorities to enter into securitisation transactions. The measures are as set out below.

2.4 **Definition** [Regulation 3(c)]. The term "securitisation transaction" is defined as a disposal (which includes both sale or assignment) by a local authority, for consideration, of its entitlement to all or part of specified revenues.

2.5 **Affordability** [Regulation 4(1)]. Part 1 of the 2003 Act establishes the "prudential" system, under which the use of borrowing and extended credit is required to be affordable. It is not known how a court might interpret Part 1 in relation to securitisation transactions, and whether "borrowing" might be construed so as to encompass the particular transaction concerned. The prudential system applies also to the use of "credit arrangements", as defined in the 2003 Act – i.e. financing options which serve as substitutes for borrowing - but securitisation does not seem to be a credit arrangement. The concern is that, if a securitisation transaction is neither borrowing nor a credit arrangement, then it is not covered by the prudential system, so an authority could securitise revenue income without any regard to affordability. However, section 7 of the 2003 Act contains a power to extend the definition of a credit arrangement. Therefore, the amendment regulations provide that securitisation transactions are to be treated as credit arrangements. This will make securitisation subject to the affordability requirement, just like borrowing and other forms of credit.

2.6 **Cost** [Regulation 4(3)]. The amendments specify how the cost of a securitisation transaction is to be determined, so that its affordability can be determined and compared fairly with that of alternative financing options. The cost is to be equal in value to the consideration received by the authority as a result of the transaction.

2.7 **Capital Expenditure** [Regulation 6]. Borrowed money and capital receipts may normally be used only for *capital* expenditure. But the lump-sum raised by securitisation, if it is not borrowing, would escape that restriction and could be used to fund *revenue* expenditure. Therefore the regulations provide that the sum received by a local authority under a securitisation transaction will be treated as a capital receipt. The 2003 regulations already specify how capital receipts are to be used and rule out their expenditure on revenue.

2.8 In addition, any authority entering into a securitisation transaction will need to consider the possible implications for its **minimum revenue provision** (MRP) liability, in accordance with the DLCG guidance (see paragraph 6.1 below). The guidance allows authorities wide discretion and DCLG does not propose to include any formal recommendations on securitisation in the guidance. However, authorities may conclude that the ongoing revenues disposed of under a securitisation transaction represent a payment to the counterparty implicitly consisting of both an annual interest element and an annual capital element. The capital element might be regarded as a full substitute for MRP and thus no additional provision would be needed. The estimated value of that capital element would then determine the annual reductions to the Capital Financing Requirement (CFR) over the life of the contract.

3. INVESTMENTS [Amendment Regulations 3(a), 3(b), 5, 7(a), 7(c)]

3.1 When prudential borrowing was introduced in 2004, authorities were in parallel given wide freedom to invest their surplus cash. The former "approved investments" regulations were replaced by statutory guidance (revised in 2010), allowing authorities to take full responsibility for investment decisions:

http://www.communities.gov.uk/documents/localgovernment/pdf/1501971.pdf

3.2 However, the 2003 Regulations preserved one restriction, in existing regulation 25(1)(d), to discourage more speculative forms of investment. If authorities acquire “share capital or loan capital” in an *individual* company, this regulation requires them to treat the transaction as capital expenditure, thus reducing the resources available for actual capital expenditure. But there is an exemption for share or loan capital acquired through a *collective investment scheme*, because then the risk is reduced by being spread across a number of companies.

3.3 **Bond purchases** [Regulation 7(a)]. The foregoing constraint is being removed in relation to *loan capital* (although this term is not defined in the regulations, it is taken normally to refer to corporate bonds). **Regulation 25(1)(d) is amended so that the acquisition of loan capital in individual companies will no longer be capital expenditure**. This means that authorities will not incur capital expenditure if they lend to individual companies by means of corporate bonds (or any other instrument or arrangement). The relaxation is of course not meant as a Government recommendation on investment practice. Investment decisions remain entirely matters for individual authorities, which need to have regard both to the DCLG investments guidance (see paragraph 3.1 above) and to CIPFA’s *Treasury Management Code*. The CIPFA Code, and accompanying guidance, detail the nature of the risks to be considered and the need to assess the appropriateness of the various categories of instrument and counterparty.

3.4 **Bond sales and redemptions** [Regulation 5]. The amendments also clarify the treatment of the proceeds when a bond is either sold in the market or reaches maturity and is redeemed by the borrower. This involves the amendment of existing regulations 7 and 7A. The underlying policy is that if the acquisition of anything counts as capital expenditure, the proceeds of its disposal should be capital receipts. So the proceeds of bond disposals are to be treated as capital receipts, if the acquisition of the bonds was prior to 1 April 2012 and counted as capital expenditure. Since bond acquisitions on or after that date will no longer be capital expenditure, their disposals will not generate capital receipts.

3.5 **Consequential amendments**.[Regulations 7(c) and 3(b)]. The foregoing changes require some minor consequential amendments. Regulation 25(3)(b), which cross-refers to loan capital, is revoked. In addition, the term “multilateral development bank” used in 25(3)(b)(i) is defined in regulation 1(5) and, since that definition would be superfluous, it is removed.

3.6 **Shares**. Purchases of *share capital* continue to be capital expenditure, unless covered by the exemptions in regulation 25(3). The main exemption is for shares in **collective investment schemes**, the definition of which, in existing regulation 1(5), is being updated slightly (regulation 3(a)) to reflect recent developments in European legislation. This merely technical change preserves the effect of the regulation and comes into force on 31 March 2012, thus applying with effect from the financial year 2011/12.

4. CAPITAL EXPENDITURE [Amendment Regulation 7(b)]

4.1 The definition of "capital expenditure" is set out in section 16 of the 2003 Act, and the Secretary of State has the power to require that expenditure of authorities be treated as if it was capital expenditure. Existing regulation 25(1)(ea) brings within that definition expenditure on the acquisition or production of assets for use by a person other than the local authority which would be capital expenditure if those assets were acquired or produced for use by the authority. Doubts have arisen about whether "production" includes the construction of an asset (such as a house), and whether "use by" includes a disposal to.

4.2 The Government considers it appropriate that such expenditure should count as capital expenditure, so that the cost can properly be met out of capital resources rather than having to be charged as a revenue cost. Uncertainty about the present wording could hinder, for example, affordable housing initiatives. Regulation 7(b) therefore amends regulation 25(1)(ea) so that it refers to expenditure on the "acquisition, production or construction of assets for use by, or disposal to, a person other than the local authority".

5. CIPFA CODES [Amendment Regulations 4(2), 8]

5.1 Two minor technical amendments are needed to reflect new terminology in codes published by CIPFA (the Chartered Institute of Public Finance and Accountancy). Since the revised CIPFA codes have already been published, these two amendments come into force on 31 March 2012 and so apply with effect from the financial year 2011/12. The changes simply preserve the effect of the existing regulations and are as follows.

5.2 Existing regulation 3, on credit arrangements, uses the term **fixed asset** which formerly appeared in CIPFA's code of practice on local authority accounting. This term is no longer used in the code and is replaced in the regulation with an equivalent expression ("non-current asset which is not a financial asset").

5.3 Existing regulation 31 lists the codes which constitute **proper practices**, including CIPFA's "Best Value Accounting Code of Practice", This has now been renamed "Service Reporting Code of Practice for Local Authorities". So the name is changed in the regulation.

6. MINIMUM REVENUE PROVISION GUIDANCE

6.1 The DCLG guidance on **Minimum Revenue Provision** (MRP), is at:

http://www.communities.gov.uk/localgovernment/localgovernmentfinance/capitalfinance/capfinguidconsultdocs/

6.2 This is to be amended slightly in the context of the HRA reforms. The aim is to ensure that authorities taking on new debt in the course of that exercise do not face inappropriate increases in their MRP liability. Additional guidance is to be included in this document as follows:-

In Part 1 (informal commentary), after paragraph 39, the following paragraph is to be inserted-

“ **HRA Reform Exercise**
39A. This initiative, on 1 April 2012, entails new debt being incurred by certain authorities, some with a previously negative HRA CFR (Capital Financing Requirement). The ensuing increase in their overall CFR would potentially raise their MRP liability - in some cases from nil to a significant level. The Secretary of State considers that, given the special circumstances of the exercise, such a consequence should not be imposed upon authorities. He therefore makes the formal recommendation (Part 2, paragraph 19(c) below) that, for the purposes of determining MRP, this increase in the CFR may be ignored, thus avoiding any impact on the revenue budget.”

In Part 2 (statutory guidance), at the end of paragraph 19, the following is to be added-

“(c) **HRA Reform Exercise**. Any increase in the CFR arising from the HRA reform exercise undertaken on 1 April 2012 may be ignored for the purposes of determining MRP.”

6.3 The revised guidance will be published shortly and in the meantime authorities should rely upon the statement given above.

7. QUERIES

7.1 Any queries on the matters set out above should be sent by e-mail to:

sarah.blackman@communities.gsi.gov.uk

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