Communities and Local Government

Changes to the capital finance system

1. Introduction

1.1 This consultation paper explains the effects of proposed amendments to the capital finance regulations, plus minor alterations to the DCLG guidance on *Minimum Revenue Provision*, and seeks the views of local authorities and all other interested parties.

1.2 The regulations to be amended are 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 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

1.3 The regulations are made under the Local Government Act 2003 ('the 2003 Act'): http://www.legislation.gov.uk/ukpga/2003/26/contents.

1.4 The changes are intended to come into force on **1 April 2012**. DCLG Housing colleagues are separately consulting on amendments to some of the regulations on the **pooling of housing capital receipts** (see paragraph 6.1 below). The two sets of amendments will be included in the same Statutory Instrument.

2. Securitisation

2.1 'Securitisation' as used in this context means the disposal of future revenues. For example, someone 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 it might be thought that it could be used as an alternative to it.

2.2 Whether any such securitisation transaction would be lawful is a matter for individual authorities to decide, taking account of the specific nature of the contract and of all relevant legislation, including, if it becomes law, Clause 1 of the Localism Bill (currently before Parliament) which provides for a ‘general power of competence’ for local authorities. Part 1 of the 2003 Act controls borrowing by local authorities. It is not known how a court might interpret Part 1 in relation to securitisation transactions, and whether “borrowing” (which has no definition in the Act) might be construed so as to encompass the particular transaction concerned.

2.3 The possible use of securitisation by local authorities gives rise to certain concerns:

a) ***Affordability***. If a securitisation transaction does not qualify as borrowing under Part 1 of the 2003 Act, then it would not be covered by the prudential system. An authority could securitise revenue income without any regard to affordability.

b) ***Capital Expenditure***. 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.

2.4 The intention is to amend the 2003 Regulations, so that if securitisation is ever lawfully used, it will be on an equal footing with borrowing. The amendments as described below do not imply any view by the Government of the lawfulness of any particular securitisation contract.

2.5 Additional provisions will be inserted in the 2003 Regulations, as follows:

a) The proposed definition of the term **‘securitisation transaction’** is the sale or assignment by a local authority, for consideration, of its entitlement to all or part of specified revenues.

b) **Securitisation transactions will become credit arrangements**. The prudential system controls apply not only to conventional borrowing but also to the use of ‘credit arrangements’ – i.e. financing options which serve as substitutes for borrowing. Securitisation does not fall within the current definition of credit arrangements. However, section 7 of the 2003 Act gives us power to extend that definition. Therefore, securitisation transactions will become credit arrangements. This will make securitisation subject to the affordability requirement and solves the problem at 2.3(a).

c) **Securitisation transactions will generate capital receipts**. The sum received by a local authority under a securitisation transaction will be treated as a capital receipt, using the power in section 9 of the 2003 Act. The 2003 regulations already specify how capital receipts are to be used and rule out their expenditure on revenue. This therefore solves the problem at 2.3(b).

3. Investments in bonds

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 last year), allowing authorities to take full responsibility for investment decisions: http://www.communities.gov.uk/documents/localgovernment/pdf/1501971.pdf

3.2 However, one restriction was preserved in the 2003 Regulations. This was to discourage more speculative forms of investment, in shares and corporate bonds. If authorities buy the shares or bonds of an *individual* company, the regulations require them to treat this transaction as ‘capital expenditure’, thus reducing the resources available for actual expenditure (regulation 25(1)(d)). But there is an exemption for shares or bonds bought through a collective scheme, such as a unit trust, because then the risk is reduced by being spread across a number of companies - see regulation 25(3)(a), and the definition in regulation 1(5) of the term ‘money market fund’ used in regulation 25.

3.3 We consider that this constraint should be removed in relation to *bonds.* As some authorities have argued, the bonds of an individual company with a triple-A credit rating may be a safer investment option than a collective scheme with a lower rating.

3.4 Therefore the proposal is to **amend regulation 25 so that purchases of the bonds of individual companies will no longer be capital expenditure**. This will be achieved by deleting the words the words ‘*or loan capital*’ in paragraph (1)(d).

3.5 The amendment regulations will also spell out the treatment of the proceeds when a bond is either sold in the market or reaches maturity and is redeemed by the borrower. The proceeds are to be treated as **capital receipts**, if the acquisition of the bond was prior to 1 April 2012 and counted as capital expenditure, but not otherwise.

3.6 Some minor consequential amendments will be needed. Regulation 25(3)(b), which cross-refers to loan capital, will be revoked. In addition, the term ‘multilateral development bank’ used in 25(3)(b)(i) is defined in regulation 1(5) and, since that definition will be superfluous, it will be removed.

3.7 This relaxation is not meant as a recommendation to invest in bonds. Investment decisions are 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.

3.8 There will be no change in relation to purchases of **shares***,* which will continue to be capital expenditure, unless covered by the exemptions in regulation 25(3). The main exemption is for shares in collective investment schemes, referred to in regulation 25(3)(a) as ‘money market funds’. The precise definition of that term, given in regulation 1(5), will be updated slightly to reflect developments in European legislation, but this is a mere technical change and the policy is unaltered.

4. Code of practice on accounting

4.1 This minor amendment is made necessary by a recent revision of the code, simply to preserve the existing effects. Existing **regulation 3**, on credit arrangements, quotes a technical 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 will be replaced in the regulation with an equivalent expression (“non-current asset which is not a financial asset”).

5. Best value accounting code

5.1 Again, this minor amendment is made necessary by a recent revision of the code. Existing **regulation 31** lists the codes which constitute proper accounting 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 will be changed in the regulation.

6. Pooling of housing capital receipts

6.1 As mentioned above (paragraph 1.4), DCLG is separately consulting on amendments to some of the 2003 Regulations relating to the “pooling” system, under which authorities are required to pay DCLG part of the capital receipts from sales of HRA assets. These changes to rationalise the system are being undertaken in parallel with the reform of the HRA system from next year.

6.2 Full details are in the consultation document: *Streamlining council housing asset management: Disposals and use of receipts*:
http://www.communities.gov.uk/documents/housing/pdf/1961898.pdf

Comments should be sent to the address given in the paper and not to that shown in paragraph 8.1 below.

7. Minimum revenue provision guidance

7.1 The current DCLG guidance on **Minimum Revenue Provision**, is at: http://www.communities.gov.uk/documents/localgovernment/pdf/1502003.pdf

This is to be amended slightly in the context of the Housing Revenue Account reforms. The aim is to ensure that authorities taking on new debt in the course of that exercise do not face increases in their Minimum Revenue Provision 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. 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(b) 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(b), the following sentence is to be added:

"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."

Any comments should be sent to the address in paragraph 8.1 below.

8. Responses

8.1 Comments on the matters set out above should be sent please by e-mail (with any attachments in MS Word), no later than **22 November 2011** to: sarah.blackman@communities.gsi.gov.uk

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