EXPLANATORY MEMORANDUM TO

THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (ENGLAND) (AMENDMENT) REGULATIONS 2012

2012 No. 265

1. This explanatory memorandum has been prepared by the Department for Communities and Local Government and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Regulations make a number of technical amendments to the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (S.I. 2003/3146) ("the 2003 Regulations"). The 2003 Regulations set out detailed provisions in relation to local authority finances, including the spending of capital receipts, the way that local authorities account for debt and accounting practices generally.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 Part 1 of the *Local Government Act 2003* ("the 2003 Act") (known informally as the "prudential" capital finance system) serves mainly to control borrowing by local authorities. It requires them to determine how much they can afford to borrow and not to borrow in excess of that amount. In determining what is affordable, they are required to have regard to a code published by CIPFA (the Chartered Institute of Public Finance and Accountancy).

4.2 Subject to those constraints, authorities are free to decide how much to borrow without seeking the Government's consent. Long-term borrowing can however normally be used only to fund *capital expenditure*, as defined in Part 1 and in the 2003 Regulations. Government consent is required for borrowing for revenue purposes and this is granted only exceptionally, because borrowing to support revenue expenditure impacts adversely on the budget deficit reduction programme.

4.3 The 2003 Regulations contain the more detailed provisions of the system, including rules on the use of capital receipts. They also modify accounting practice in various ways to prevent adverse impacts on authorities' revenue resources.

4.4 With the exception of the amendments made by regulations 1 to 3(a), 4(2), 7(b) and 8, which apply to the financial year ending 31st March 2012, the amendments will apply to the local authority financial year which begins on 1st April 2012 and to subsequent years.

5. Territorial Extent and Application

5.1 This instrument applies to England.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- What is being done and why

7.1 The amendments to the 2003 Regulations cover five main issues which are relatively independent of each other and are dealt with under separate headings below.

SECURITISATION [Regulations 3(c), 4(1) and (3) and 6]

7.2 "Securitisation" means the sale of future revenues. For example, a landlord receiving rents from commercial properties might transfer the entitlement to that income to a bank for a long period (typically, 20 years or more), in exchange for an immediate lump-sum payment. Technically, securitisation is the *sale* of an asset (the revenue stream) and not borrowing. But the strategy achieves the same result as borrowing: a substantial sum is raised for immediate expenditure in return for giving up long-term revenue income.

7.3 Local authorities have previously regarded securitisation as of dubious legality, because there were no express powers or clear implied powers permitting it. However, that attitude might change with the coming into force of section 1 of the *Localism Act 2011,* which provides for a "general power of competence", giving authorities the powers of an individual person (although subject to legal restrictions). The possible use of securitisation by any authority gives rise to two concerns which these regulations address.

7.4 As noted above (paragraph 4.1), the prudential capital finance system in Part 1 of the 2003 Act controls borrowing by local authorities. It requires them not to borrow more than they can afford and applies similar controls to other forms of long-term credit ("credit arrangements") such as property leases. However, securitisation probably does not count as borrowing (while there is no legal definition of "borrowing", certainly in accounting terms securitisation is not borrowing, although only the courts can rule on whether securitisation would be "borrowing" for the purposes of Part 1 of the 2003 Act), and it does not constitute a credit arrangement. So in all likelihood it is not covered by the requirement to be affordable. Securitisation could thus be used to evade the

prudential controls, leading to the incurring of unaffordable liabilities. This is the first area of concern.

7.5 The new regulations seek to remove this potentially perverse incentive to use securitisation. **Regulation 3(c)** paves the way by defining a "securitisation transaction" as the sale or assignment by a local authority of its entitlement to all or part of specified revenues.

7.6 **Regulation 4(1)** then tackles affordability. As noted above, the prudential system controls apply not only to conventional borrowing but also to credit arrangements. Under section 7 of the 2003 Act, the definition of a credit arrangement may be extended by regulations. By virtue of that power, regulation 4(1) provides **that securitisation transactions, as defined in regulation 3(c), will be credit arrangements**. In this way, securitisation will be made fully subject to the affordability requirement.

7.7 This measure will not prevent authorities from using securitisation. The intention is to ensure that, if securitisation is ever used, it will be on an equal footing with borrowing and other forms of credit. Like the latter financing options, securitisation will have to be judged affordable. **Regulation 4(3)** specifies how the **cost** of a securitisation transaction is to be determined, so that its affordability can be compared fairly with that of the alternative option of borrowing, and it is the amount equal in value to the consideration received by the authority as a result of the transaction.

7.8 **Regulation 6** deals with the second concern about securitisation. Government economic policy requires that borrowed money and "capital receipts" (i.e. receipts from the sale of capital assets, such as property sales proceeds) may normally be used only for *capital* spending (e.g. buying land or constructing buildings). But the lump-sum raised by securitisation would escape that restriction and could be used to fund *revenue* expenditure (e.g. salaries and running costs). Again, this could offer a perverse incentive to use securitisation rather than borrowing. It could lead to imprudent action and would have adverse implications for the national economy. Regulation 6 therefore provides (by virtue of section 9 of the 2003 Act) 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.

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

7.9 When the prudential system was introduced, authorities were in parallel given wide freedom to invest their surplus cash. 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, they are required (by existing regulation 25) to treat this transaction as "capital expenditure", thus reducing the resources available for actual capital expenditure. But there is an exemption for shares or bonds bought through a *collective* investment scheme, because then the risk is reduced by being spread across a number of companies

7.10 Authorities have argued that the bonds of an individual company with a high credit rating may be a safer investment option than a collective scheme with a lower rating. The Government has decided that authorities should have greater flexibility to explore such options at their own risk. **Regulations 7(a) and (c) amend regulation 25 so that purchases of the bonds of individual companies will no longer be capital expenditure**. A minor consequential amendment is made by regulation 3(b).

7.11 **Shares** are seen as riskier and will continue to score as capital expenditure unless undertaken through collective schemes. **Regulation 3(a)** slightly updates the definition of a collective investment scheme to reflect minor technical changes in European legislation.

7.12 **Regulation 5** clarifies 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.

CAPITAL EXPENDITURE [Regulation 7(b)]

7.13 The definition of "capital expenditure" is set out in section 16 of the 2003 Act, and the Secretary of State then 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. 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, vital 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".

CREDIT ARRANGEMENTS [Regulation 4(2)]

7.14 Existing regulation 3, on credit arrangements, quotes a technical term ("fixed asset") which formerly appeared in the code of practice on local authority accounting produced by CIPFA (the Chartered Institute of Public Finance and Accountancy). The 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”). The effect of the existing regulation is thus preserved and the change merely keeps pace with the change of terminology.

PROPER PRACTICES [Regulation 8]

7.15 This is another minor amendment made necessary by a recent revision of a CIPFA 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, preserving the effect of the existing regulation.

- Consolidation

7.16 No consolidation is proposed at this stage since further amendments are likely to be required in the near future, particularly in relation to changes in the housing finance system. Other changes may be required in the slightly longer term to reflect changes in accounting practice relating to leases.

8. Consultation outcome

8.1 All local authorities were consulted about the proposals on 11 October 2011. Responses were requested by 22 November 2011, in accordance with the agreement with local government that consultations on urgent technical changes should not exceed 6 weeks. Over 30 responses were received from individual authorities and other stakeholders including local government associations, CIPFA and private sector consultants. Consultees were content with the proposals. Regulations 4(3) and 7(b) were not consulted on but were prompted by suggestions from consultees. There were some requests for guidance on accounting and legal implications which will be addressed in the informal commentary mentioned below in paragraph 9.1. The main points made in the responses and the Government’s decisions, have been published on the DCLG website at:
http://www.communities.gov.uk/localgovernment/publications/consultations/

9. Guidance

9.1 There will be no formal Government guidance associated with this instrument. An informal commentary will be published on the DCLG website when the instrument is laid and the link to it and the instrument will at that time be emailed to local authority Finance Directors and all others who were consulted on the regulations.

10. Impact

10.1 There is no impact on business, charities or voluntary bodies.

10.2 The impact on the public sector is in all cases either helpful or neutral.

10.3 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 These measures, along with the rest of the capital finance system, will be kept under review by the department in liaison with the local government associations, CIPFA and other interested parties.

13. Contact

Sarah Blackman at the Department for Communities and Local Government Tel: 030 34441765 or email: sarah.blackman@communities.gsi.gov.uk can answer any queries regarding the instrument.