



Ministry of Housing,
Communities &
Local Government

Consultation on mitigating the impact of fair
value movements on pooled investment
funds on local authority budget setting



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Scope of the consultation

Topic of this consultation:	Consultation on mitigating the impact of fair value movements on pooled investment funds on local authority budget setting
Scope of this consultation:	This consultation seeks views on the proposals for amending the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
Geographical scope:	These proposals relate to England only.
Impact Assessment:	The proposed policy changes are not within the scope of the Reducing Regulation Committee and so do not need an Impact Assessment for this purpose.

Basic Information

To:	The consultation is aimed at local authorities and other interested parties
Body/bodies responsible for the consultation:	Ministry of Housing Communities and Local Governmnet
Duration:	This consultation will last from 25 July 2018 and will conclude on 28 September 2018.
Enquiries:	For any enquiries about the consultation please contact Geoffrey Whitby at: geoffrey.whitby@communitites.gsi.gov.uk
How to respond:	<p>To respond to this consultation, please e-mail: LA.FinancialControlFramework@communities.gsi.gov.uk</p> <p>When responding, please ensure you have the words “Consultation on the proposed changes to the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as amended)” in the email subject line.</p> <p>Alternatively you can write to: Geoffrey Whitby Ministry of Housing, Communities and Local Government 2nd floor, SE Quarter Fry Building 2 Marsham Street LONDON SW1P 4DF</p> <p>When responding, please state whether you are responding as an individual or representing the views of an organisation or a local authority and include:</p>

- | | |
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| | <ul style="list-style-type: none">- your name,- your position (if applicable),- the name of organisation (if applicable),- an address (including post-code),- an email address, and- a contact telephone number |
|--|--|

Introduction

1. The Ministry of Housing, Communities and Local Government has policy responsibility for local authority accounting. In practice, under Regulation 31(a) of the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* the Chartered Institute for Public Finance and Accountancy (CIPFA) has responsibility for setting 'proper practices' for local authority accounting.
2. Under the Regulations, local authorities must follow CIPFA's Code of Practice on Local Authority Accounting in the United Kingdom, as amended or reissued, as a code of practice containing proper accounting practices. This Statutory Code is reissued in every financial year. The code applies only to principal authorities.¹
3. The Government can modify local authorities' duties to follow the proper practices as set out in the Code on Local Authority Accounting, by including specific provisions in the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003*.
4. The Government regularly reviews all new accounting standards and how these have been introduced into proper practices, to see if any new statutory overrides are necessary. However, statutory overrides are only normally introduced by the Government in strictly limited circumstances where they are absolutely necessary. The Government is conscious that each new statutory override introduced means that local authority accounts will differ from accounts prepared by other entities reducing their transparency and comparability
5. The sector has made representations to Government claiming that some of the provisions in IFRS 9 *Financial Instruments* will have negative impacts. We are consulting on potential mitigations to those provisions.

¹ The definition of major authorities includes the following types of body: a County Council in England; a District Council; a London borough council, the Greater London Authority, the Council of the Isles of Scilly, a Police and Crime Commission for a police area in England, The Commissioner of Police of the Metropolis, a Fire and Rescue Authority in England, a Combined Authority, the Broads Authority and a National Park Authority for a National Park in England.

PROPOSED CHANGES TO THE CAPITAL FINANCE AND ACCOUNTING REGULATIONS AS A RESULT OF THE INTRODUCTION OF IFRS 9

Introduction

7. Local authorities will be required to comply with *IFRS 9: Financial Instruments* with effect from the 2018-19 financial year. *IFRS 9* replaces *IAS 39: Financial Instruments – Recognition and Measurement*. It is meant to respond to criticisms that *IAS 39* *IAS 39 contained many different classification categories and associated impairment models*. Consequently *IAS 39* was regarded as too complex, inconsistent with the way that entities manage their businesses and risk, did not recognise credit losses on loans and receivables early enough; and did not appropriately treat gains and losses on investment products such as pooled funds. For these reasons, *IAS 39* was always on the list for replacement. However, the perception that the financial crisis was in part made more acute by entities deferring recognition of credit losses on loans and receivables for as long as possible, made its replacement higher priority.

Possible consequences of IFRS 9

8. *IFRS 9* updates the accounting treatment and risk disclosures to be included in financial statements by entities that hold financial instruments.
9. There are a number of possible consequences falling out of the introduction of *IFRS 9*. Those that are likely to be most relevant to local authorities are:
 - a. **More income statement volatility.** *IFRS 9* raises the likelihood that more assets will have to be measured at fair value, with changes in fair value recognised through profit and loss. This is most likely to impact local authorities with investments in pooled investment funds.
 - b. **Earlier recognition of impairment losses on receivables and loans, including trade receivables.** Entities will be required to consider providing for possible future credit losses from the first reporting period in which a loan or receivable is recognised in the accounts. Local authorities will need to consider whether they have any trade receivables or loans, for example loans made to local SMEs that fall within scope of the standard.
 - c. **Significant new disclosure requirements.** Those entities that are more significantly impacted by these new disclosure requirements may need new systems and processes to collect the necessary data.

Local Authority Accounting

10. The CIPFA/LASAAC Accounting Code Board considered the potential impacts of *IFRS 9* at its meeting of 8 November 2017. As per the statement available from the

CIPFA/LASAAC page on CIPFA's website², the Board considered the relevance of *IFRS 9* to local authority investments and concluded that full adoption of the Standard in proper practices was appropriate. Some Board members expressed sympathy for the view that some form of statutory override might be appropriate, particularly relating to the treatment of existing unrealised gains or losses on transition at 1 April 2018. However, the Board recognised that the decisions on statutory overrides rest with central and the devolved governments, and it was outside its remit to comment on whether any override was appropriate/

11. Both FRAB and CIPFA have concluded that tax debtors do not count as trade receivables and therefore are outside the scope of *IFRS 9*. This is because taxation is not an exchange transaction as defined in accounting standards and therefore does not generate trade receivables. FRAB and CIPFA/LASAAC have also concluded that the expected loss on trade receivables where the counterparty is covered by crown guarantee or the debt is protected under statute (i.e. the counterparty is another local authority) is £nil.
12. Within this accounting framework, it will be for each local authority to decide how to account for any transaction, following consultation with the external auditor where appropriate. In doing so local authorities are expected to follow proper practices as set out in the Code of Practice on Local Authority Accounting in the United Kingdom. The Government will not be issuing any guidance on how any specific financial instrument should be accounted for.

Holdings in pooled investment funds

13. Many local authorities have holdings in pooled investment funds. Pooled investment funds are viewed as a safe alternative investment to bank deposits and are often used by local authorities as a way to manage cash efficiently. In theory, pooled investment funds offer investors a larger diversification than regular bank deposits and generate higher returns.
14. Long considered to be an investment with almost zero volatility, the sub-prime crisis in 2007-8 and the Eurozone debt crisis in 2011 highlighted that pooled investment funds are inherently exposed to credit risk, interest rate risk, exchange rate risk and liquidity risk in the same way as other investment products.
15. Most pooled investment funds are backed by a diversified portfolio of short dated assets. However many local authorities have invested in the CCLA Local Authorities'

² <http://www.cipfa.org/policy-and-guidance/technical-panels-and-boards/cipfa-lasaac-local-authority-code-board>

Property Fund, which as the name suggests is primarily backed by a single asset class, commercial property. The size of this fund was £976m as at 31 March 2018.³

16. One of the consequences of the introduction of IFRS 9 is that investments in pooled investment funds, which previously have been accounted for at fair value through other comprehensive income, may now need to be accounted for at fair value through profit and loss. If any local authorities have pooled investment funds that now need to be accounted for at fair value through profit and loss, for the first time changes in the market value of the fund will directly impact on non-ringfenced revenue reserves and annual balanced budget calculations.
17. The Government fully supports the objectives set out by the IASB, on the introduction of IFRS 9 and believes that it is right that local authorities are required to recognise the real cost of holding pooled investment funds in the same way as any other entity.
18. One of the aims of IFRS 9 is to ensure that all reporting entities recognise the risks that they are running as a result of their borrowing and investment activities. Introducing a statutory override would mean that local authorities are not subject to the same requirements as the private sector on when to recognise that risk.
19. At the same time, the Government recognises that many local authorities have built up holdings in pooled investment funds over a number of years, primarily for treasury management purposes rather than with the intention of making a profit. The Government also recognises that a number of the funds that local authorities currently invest in were set up specifically for that purpose under section 11 of the *Trustee Investments Act 1961*.
20. The Government also recognises that requiring local authorities to recognise fair value movements on pooled investment assets could mean that there is less money available to fund services. This is because fair value losses will need to be recognised as expenditure. However, it is unlikely that local authorities will want to use fair value profits to fund service delivery unless they are planning to dispose of the relevant assets. Instead it would be rational for local authorities to build up earmarked reserves to cover any future losses.
21. Finally, the Government needs to be mindful of how accounting for pooled investment funds interacts with accounting for other transactions, where there are already statutory overrides. In England investment properties and most types of shareholding are covered by the definition of capital expenditure, shielding revenue from the implication of losses. But loan capital, money market funds and the CCLA Local Authority Property Fund are not. Local Authorities have indicated to the Government that if a statutory

³ https://www.ccla.co.uk/sites/default/files/D10%20LAMIT%20Property%20Fund_0.pdf

override for pooled investment funds is not introduced, there is a risk that it would be seen as incentivising riskier investments.

22. Having considered the risks and incentives, the Government proposes introducing a time limited statutory override, **requiring local authorities to reverse out fair value movements recognised on pooled investment funds to unusable reserves for a period of three years to 1 April 2021.**
23. Local authorities would still be required to account for all financial instruments in accordance with proper practices. However, for the period covered by the override fair value movements would not impact on the balanced budget requirement or on the quantum of funds available to support delivery of services.
24. Whilst the Government believes that it is desirable that ultimately, local authorities account for holdings in pooled investment funds in the same way as any other reporting entity, it is proposing a fairly long override period. This is because it recognises that local authorities need time to either divest themselves of financial instruments that they no longer wanted to bear the risks of holding in an orderly way, or to build up revenue reserves to mitigate the impact of fair value movements on instruments they wanted to continue to hold.

Q1. Do you agree that local authorities should be allowed to reverse out the impact of fair value movements on pooled investment funds to unusable reserves? If not, why not and what alternative approach would you propose?

Q2. Do you agree that the statutory override should be time limited? If not, why not? If it is time limited, is a three year period appropriate?

Q3. If you agree that local authorities should be allowed to reverse out the impact of fair value movements on pooled investment funds should this be limited to pooled property funds or apply to all pooled investment funds, and why?

25. The Government believes that it is important that the users of local authority accounts have clear visibility of potential profits or losses relating to investments in money market funds. To aid transparency the Government believes that fair value movements relating to IFRS 9 overrides should be held in a reserve that is separately disclosed in the Unusable Reserves note to the Statutory Accounts.

Q4. Do you agree that local authorities should be required to disclose the net profit/loss reversed out of the general fund to mitigate the impact of the introduction of IFRS 9, as a separate line in the Unusable Reserves note? If not, please explain why not and detail the alternative approach you would prefer.

Earlier recognition of impairments on loans and trade receivables

26. Following the introduction of IFRS 9, entities will be required to consider providing for possible future credit losses from the first reporting period in which a loan or receivable is recognised in the accounts. Local authorities will need to consider whether they have any trade receivables or loans, for example loans made to local SMEs that fall within scope of the standard.
27. Where local authorities have loans and trade receivables that fall within the scope of the standard they will need to provide for future losses on an expected loss model. This is likely to increase the bad debt provision that local authorities with significant loan portfolios are required to make in the year that the standard is implemented.
28. Whilst recognising that a small number of local authorities may have to recognise significant impairments, the Government does not intend to create overrides to mitigate the impact of the change in the impairment allowances model from incurred losses to expected losses on transition to *IFRS 9*. This is because local authorities who will be required to recognise substantial impairments have taken deliberate decisions to take on a more risky loan book and it is right that they recognise the potential costs of that strategy.
29. In addition the incurred loss model is widely recognised as imprudent and historically most local authorities have either adopted a prudent approach in estimating the value of debtors or supplemented their impairment allowances by setting aside earmarked reserves to cover the expected loss position.

Q5. Do you agree that the Government should not create a statutory override to protect local authorities from the impact of the move to an expected loss model to calculate impairments on loans and debt? If you disagree please explain why with case study examples if relevant.

Disclosure

30. The new standard includes a number of enhanced disclosure requirements. The changes to disclosure range from making consequential changes to existing requirements, to significant new requirements. Preparing the new disclosures may require local authorities to develop new systems and processes to collect the required information.
31. Whilst the Government recognises that first time implementation of the new disclosure requirements may impose an administrative burden, it believes that this is outweighed by the benefits to users of the accounts of enhanced transparency, where investments in financial instruments are material.

Q6. Do you agree that the Government should not create a statutory override for any of the disclosure requirements introduced by the new standard?

OTHER CHANGES TO THE CAPITAL FINANCE AND ACCOUNTING REGULATIONS

32. Between 2010 and 2012, many authorities became liable for large back-pay awards in relation to historical pay inequalities. Financial provision for probable future liabilities, including equal pay back-pay awards, has to be made in the financial year when the liability is first identified, rather than in the year when the actual payment falls due. In the case of equal pay, authorities are likely to have identified a potential liability significantly in advance of having to make the payment. Scoring liabilities when first identified could therefore cause authorities serious budgetary difficulties.
33. To protect authorities, a Regulation was introduced that offered authorities a breathing space, allowing them not to charge back-pay awards to their revenues until they made the payments. Originally due to expire in 2011, it was extended until 2013 and further extended to 2018. Local authorities are still required to recognise expenditure when they make payments.

Q7. Do you agree with the proposal to extend the Regulation allowing local authorities not to charge back-pay awards for equal pay claims for a further two years to 2020? If not, please explain why not.

IMPLEMENTATION TIMETABLE

23. The Government would like the updated Regulations to take effect for the 2018-19 financial year. This would align the updated Regulations to the IFRS 9 adoption date.

Question 8: Do you agree that the updated Regulations should take effect for the 2018-19 financial year and what would be the implications of not doing so?

PUBLIC SECTOR EQUALITY DUTY

24. We do not believe that there are any public sector equality duty implications of this proposed consultation. However, we welcome any representations respondents wish to make on this issue.

About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA), the General Data Protection Regulations, and the Environmental Information Regulations 2004.)

If you want the information that you provide to be treated as confidential, please be aware that, as a public authority, the Department is bound by the Freedom of Information Act and may therefore be obliged to disclose all or some of the information you provide. . In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Ministry of Housing, Communities and Local Government will process your personal data in accordance with the law and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact us via the [complaints procedure](#).

Annex A

Personal data

The following is to explain your rights and give you the information you are be entitled to under the Data Protection Act 2018.

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the data controller and contact details of our Data Protection Officer

The Ministry of Housing, Communities and Local Government (MHCLG) is the data controller. The Data Protection Officer can be contacted at dataprotection@communities.gsi.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

3. With whom we will be sharing your personal data

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for two years from the closure of the consultation

5. Your rights, e.g. access, rectification, erasure

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right:

- a. to see what data we have about you
- b. to ask us to stop using your data, but keep it on record
- c. to ask to have all or some of your data deleted or corrected
- d. to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system.