8 Financial transactions

8.1 Policy lending is a financial transaction in National Accounts, rather than resource or capital expenditure. It includes loans given and shares purchased, net of repayments and sales of shares.

8.2 This chapter:

- Gives an overview of financial transactions
- Details specific examples of transactions
- Provides guidance on budgeting and accounting treatments
- Describes some of the rules in respect of certain transactions in more detail
- Sets out guidance on the timing of recording transactions

8.3 Policy lending to the private sector adds to public sector net debt. Consequently net lending to bodies outside the budgeting boundary scores to a department's Capital budget even though the transactions are not classified as capital in National Accounts.

8.4 Policy lending excludes financial assets acquired to manage the department's liquidity such as bank deposits and balances in the Government Banking Service (GBS).

Loans other than student loans

8.5 Loans are payments made to another party where the expectation is that the payment will be wholly repaid, normally with interest, and normally to a fixed regular payment schedule.

8.6 Loans need to be distinguished from deposits:

- Loans include any debt-based financial assets acquired by the department, which are not treated as liquid in the National Accounts. Typically these assets occur where the department lends money as an act of policy. So, for example, we lend to students or to certain sorts of business because we wish to support them in this way; and
- Deposits are also a form of lending, but are made because the public body has spare cash and needs to put it somewhere. In National Accounts deposits are treated as liquid assets. Typically deposits are placed with a bank in order to obtain the maximum risk-weighted rate of interest. There is no intention to support the institution holding the deposit.

8.7 The making and withdrawing of deposits do not score in budgets, though deposits themselves may attract interest income.

8.8 The budget treatment of a loan is:

- The Resource budget will score:

  a Interest income (negative Resource DEL)

  b Revaluations to fair value (Resource AME)

c Write-off of debt (Resource AME)

- The Capital budget will score:

d Net lending (i.e. transactions in loan principal).

8.9 Normally, lending scores in DEL. Where exceptionally a loan scheme is in AME (e.g. Social Fund), generally the associated resource transactions will score in Resource AME. An exception to this is debt write-offs by mutual consent which scores in DEL for AME lending.

Student loans

Impairments

8.10 Because of the soft terms on which student loans are offered, the departments and devolved governments who issue student loans must calculate the impairment resulting from the cost at which the loans are delivered.

8.11 **Subsidy impairment** – Student loans are offered at a loan rate lower than government's cost of capital, as such over the lifetime of the loans there is an effective subsidy. The main student loans impairment is to account for this subsidy and will be valued as the difference between the expected income from the loans and the costs of delivering them at government's cost of capital (agreed as 2.2 per cent for loans).

8.12 **Impairment relating to policy write offs** – The second impairment is to account for "policy" write-offs; when loans are issued, it is the policy of the department that these will be written off in certain circumstances, e.g. death or disability of the debt owner or age of the debt. These amounts are recognised at the point the loan is made. Where these debts are deemed to be policy write offs, they will be recorded as capital transfers in the National Accounts at the time the loan is formally written-off; there is however no transaction in Departmental Accounts or budgets.

8.13 The arrangements described in this chapter for student loans are only applicable to loan books still owned by the government and do not apply to loans which have been sold (such as the 1998-99 student loan book)

8.14 In August 2013, loans were introduced in further education for learners aged 24 and above, studying courses at level three and above. The following guidance applies to Further Education student loans, Higher Education student loans currently subject to a sale (Pre 2012 reform Income Contingent Repayment student loan book) and Higher Education student loans not subject to a sale. The following budgeting treatment will apply equally to England and, where appropriate, the Devolved Administrations

Budgeting treatment of student loans

8.15 In period one:

1. The Treasury will set a target impairment for the loans,
2. Cash value of the loans issued are a charge on Capital AME,
3. When loans are issued the impairments are charged to RDEL. The budget for this spending is ring-fenced within RDEL, which may not be reprioritised to other RDEL or CDEL spending, although transfers across from non ring-fenced RDEL are allowable without Treasury agreement .

8.16 In the Departmental Accounts, the net effect of these two adjustments is to provide the net present value of the loan book.

8.17 In period two and subsequent periods budgets will record the following impacts:

4 The interest receivable from the loans scores as a benefit to resource AME. This is irrespective of the fact that no cash may have been received.

5 The interest receivable will be capitalised and a cost to Capital AME. This is equal and opposite to (4), and reflects the fact that capitalising interest is effectively new lending.

6 The recalculation of the impairment – i.e. the unwinding of the discount – scores as a benefit to resource AME. The discount is created and unwound at the government's long term cost of borrowing (agreed as 2.2 per cent for loans).

8.18 In period three:

7 Repayments of principal, or of capitalised interest, are treated as negative Capital AME.

Revaluations of impairments

Further Education student loans and Higher Education student loans currently subject to a sale

8.19 Any revaluations of the impairment that occur periodically because the original values were based on forecasts that have turned out to be incorrect, or because of updates made to the student loans model, and which go beyond the target impairment set by the Treasury will be charged to RDEL, in the same way that the original impairment is charged to RDEL.

Higher Education student loans not subject to a sale

8.20 Any revaluations of the impairment that occur periodically because the original values were based on forecasts that have turned out to be incorrect, or because of updates made to the student loans model, and which go beyond the target impairment set by the Treasury, will be charged to RDEL over a 30 year period (unless departments decide to cover the costs from their RDEL over a shorter timeframe). One thirtieth of the total cost will be charged to no ring-fenced RDEL each year for 30 years, with the residual amount each year charged to RAME. The net effect of these entries in RDEL and RAME each year will equal the annual impairment charge due to these forecast changes. Revaluations of the impairment that occur for any other reason will be charged to RDEL in full and in-year, in the same way that the original impairment is charged to RDEL.

8.21 In all cases any adjustments to the impairment arising from a change to the discount rate will be treated as a change of accounting policy and in budgets treated as a classification change.

Equity transactions

8.22 Purchase and sale of shares in private sector bodies scores in Capital DEL.

8.23 Note that purchase or sale of shares will affect the amount of control the public sector has over the corporate actions of a body. Where this transfer of control is significant then departments should consider the impact on classification of the body – see Chapter 1 for details of classification.

Privatisation proceeds

8.24 Privatisation proceeds score in AME, even where the asset or business being sold was on a DEL programme.

8.25 Sale of shares in a private sector PPP is the disposal of a financial asset by the department. As a form of privatisation, the income scores as a benefit to the Capital budget AME.

8.26 Sale of shares in a public sector PPP increases the public sectors financial liabilities; this increase does not affect net debt as equity liabilities are excluded from measurement of PSND. As above, the income scores as a benefit to Capital AME.

Financial guarantee contracts

8.27 Where, under IAS 39, departments are judged to have entered into a financial guarantee contract the treatment in budgets should generally follow the accounting. Budgeting will follow the resource accounting treatment for the initial recognition, and revaluation of these contracts on balance sheet.

8.28 Since neither contingent liabilities nor provisions are recorded in National Accounts, movements in guarantee contracts will have no impact on the fiscal position unless they are called. Financial guarantee contracts impact on budgets in the following ways:

- An initial resource AME cost when the guarantee is provided; this will be recorded as the balance sheet value of the contract.
- Where revaluations of these contracts go through the SoCNE they will be recorded as further resource AME benefits / costs.
- The utilisation of the guarantee will score as a benefit in resource AME.
- When the contract is called, any payments out will score in departments' Capital DEL budgets.

8.29 For details on payout against financial guarantees see separate chapter on Capital budgets.

All financial guarantees

8.30 Regardless of whether Departmental Accounts recognise a financial guarantee contract, any new financial guarantees or letters of comfort should be given the same consideration as entering into contingent liabilities as set out in Chapter 3.

8.31 Departments must also show that the budgetary implications of the guarantee will be affordable within existing budgetary allocations. At the point of making the guarantee, departments must make allocations in plans allowing sufficient CDEL to cover payments out against the guarantee. In particular departments should make an assessment of the probability distribution of different levels of payout and ensure that the planned CDEL is sufficient to cover this payout with a high degree of confidence.

8.32 Where payout against the guarantees will be outside of the current SR period, departments should discuss handling with Treasury.

Exchange rate movements

8.33 Departments may engage in transactions denominated in a foreign currency. Where there is a timing difference between the transaction being recorded in accounts and the cash being paid, any movements in the exchange rate with the foreign currency will affect the value of the creditor/debtor.

8.34 Departments should record movements in exchange rate as follows:

- At the point the income/expenditure is recognised in accounts, departments should record the impact in AME budgets.
- When exchange rates fluctuate the revaluations of the debtor/creditor should be recorded as income/cost in AME budgets with the same timing and value as shown in accounts.

- When the cash is paid there is no impact in the SoCNE, but the cumulative AME transactions should be switched to the DEL budget.

8.35 Departments have the option to hedge against exchange rate risks to protect their budgets against adverse movements. Guidance on recording hedging is included below.

Exchange rate hedging

8.36 Where departments carry out transactions in foreign currencies, their expenditure or income will be subject to the risk of exchange rates moving unfavourably. Departments have the option of hedging against this risk to gain certainty on outcomes, and mitigate against the risk of unfavourable movements in the exchange rate. Managing Public Money contains more detail on the appropriateness of hedging.

8.37 National Accounts treats a forward contract used in a hedge in the same way as any other financial instrument. So any revaluations over the life of the contract would score to the revaluation account; and at maturity of the contract all flows are recorded as financial transactions.

8.38 In order to maintain hedging as a useable option in budgets, the budgeting does not follow the National Accounting treatment in this case. Instead the benefits / costs of a hedge are realised when the department incurs the associated expenditure or receives the income.

8.39 The following items must be recorded in budgets for exchange rate hedges:

- Capital DEL
  - a Cost of purchasing the initial forward contract (usually this will be zero).
  - b Any capital expenditure funded through the forward contract. This should be valued at the daily spot rate at the point of purchase.
  - c The difference between the value of b and the value of the capital expenditure at the forward contract rate.
- Resource DEL
  - d Any current expenditure funded through the forward contract. This should be valued at the daily spot rate at the point of purchase.
  - e The difference between the value of d and the value of the current expenditure at the forward contract rate.
- Resource AME
  - f Revaluations of the contract whilst held by the department.

8.40 This recording is necessary to capture the correct treatment in both budgets and National Accounts. A basic worked example of the recording of an exchange rate hedge is available in Appendix 1.

8.41 When hedging against a specific cost or income stream, departments may find that the timing of the budgeting impacts for exchange rate moves are different to the timing of the hedging impacts. Where departments find this creates pressure in their budgets they should discuss the correct treatment with Treasury.

Appendix 1 to chapter 8: Example exchange rate hedge

Date	Transaction	Exch rate £1 =	Budgeting Impact		
			RDEL (000's)	RAME (000's)	CDEL (000's)
1 April	Enter into contract to buy $200,000 on 1 January at $2 = £1	$2			0
I July	Exchange rate changes	$1.50		-33.3	
1 October	Exchange rate changes	$1.75		19	
1 January	Forward contract matures	$1.75	-3.6		-1.07
	Spend $150,000 on capital procurement				85.7
	Spend $50,000 on current procurement		28.6		
	Totals		**25**	**-14.3**	**75**

8.42 Note: the £33,300 credit to AME represents the gain on the forward contract from the movement in the exchange rate. The subsequent £19,000 charge represents the loss on the subsequent exchange rate move. The ultimate credits to RDEL and CDEL represent the net gain, split by the ultimate use of the cash. In the example, the gain on the contract is £14,300 of which £3,600 has been used in RDEL and £10,700 in CDEL, matching the split of the expenditure of the forward contract was bought to cover.