

## **REGULATORY APPRAISAL**

### **LOCAL GOVERNMENT, WALES**

#### **THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (WALES) (AMENDMENT) REGULATIONS 2007**

##### **Background**

1. The Local Government Act 2003, together with Regulations made under it, enabled major changes to be made to local authorities' capital finance and accounting and those changes became operative for financial years commencing 1 April 2004. The relevant sections are contained in Part 1 of the Act. They replaced the previous capital finance regime under Part IV of the Local Government and Housing Act 1989.
2. This major policy change was initially consulted upon by the Welsh Assembly Government in 'Simplifying the System' (September 2000) on the basis that the system then in operation blurred accountability, limited local financial freedom and had become an obstacle to securing effective capital investment. Following this consultation, in 'Freedom and Responsibility in Local Government' (March 2002) the clear intention was expressed by the Welsh Assembly Government to support primary legislation to give effect to a new system of local authority capital finance. This system has come to be known as the 'Prudential Regime'.
3. The 'Prudential Regime' must be looked at in terms of each of its component parts. Perhaps the most significant in relation to the proposed regulation changes are:-
  - the legislative framework as set out in the 2003 Act;
  - the supporting secondary legislation, which 'fleshes out' the broad intentions laid out in the primary legislation;
  - the Chartered Institute For Public Finance and Accounting (CIPFA) 'Prudential Code for Capital Finance in Local Authorities'; and
  - other professional codes of practice and statements such as the CIPFA Treasury Management code and the Statement of Recommended Practice for Local Authority Accounting (SORP).
4. It must be recognised that no single component will achieve all of the objectives of the Prudential Regime, but taken as a whole, the system should be capable of achieving the objectives.
5. Therefore, the intention is that the primary legislation should set the broad framework of the system, supported by secondary legislation, with the detail of the system being contained in professional codes of practice and compliance, which form part of the audit process within local authorities.
6. Following discussion with the accounting setting body CIPFA regarding proposed changes to the CIPFA 2007 SORP it became clear that as a result of adopting the financial reporting Standard (FRS) 26 there was likely to be an effect on the revenue accounts of local authorities in three particular areas – premiums, discounts and "soft loans". FRS26 is an accounting standard that is mainly linked to private sector companies and tackles "Financial Instruments – Measurement". Secondly an issue has arisen in respect of an accounting requirement that would require local authorities to

ear mark and hold funds in a provision for the future payment of back pay arrears irrespective of when these were to be paid.

## **Purpose and intended effect of the measure**

### Premiums, Discounts and Soft loans

7. These Regulations seek to mitigate or neutralise the revenue impact of the changes for the existing positions held by authorities and in future ensure authorities can maintain effective treasury management activities.
8. Premiums and discounts are a payment or receipt from a lender, which is due or payable on refinancing loan debt. Under the proposed SORP changes authorities would need to charge premiums and discounts immediately to a revenue account on refinancing debt. This goes against established practice and would constrain effective Treasury management activities. The Regulations aim to mitigate this accounting change.
9. Similarly, “soft loans” are a means used to provide loans at a beneficial interest rate to an organisation in furtherance of the remit of a local authority. Following implementation of FRS26 any authority having provided these loans or committing to them may be financially disadvantaged due to the way interest charges will need to be charged to a revenue account as from 1 April 2007. The intent is, therefore, to ensure authorities are not discouraged or disadvantaged if they wish to achieve their objectives by issuing these loans to third parties.

### Equal Pay Provisions

10. The regulation relating to equal pay will address the issue that will arise as a result of Equal Pay legislation, which has highlighted the potential liability to pay arrears of Back Pay to certain employees. Accounting convention will require at the end of this financial year for local authorities to estimate and earmark funds to settle this liability, irrespective of when and indeed if these arrears will be paid. This could mean that authorities are sitting on earmarked reserves for a number of years until such time as the arrears are paid (or not). This regulation will allow authorities the reassurance that provision does not need to be created until the point at which a settlement is reached on this matter. The regulation is time bound and will only have effect until 1 April 2011, when all such claims should have been actioned.

## **Risk Assessment**

11. It is not considered that any of the proposed technical regulatory amendments will pose any significant risks to local authorities when implemented. All of the Regulations are in response to new or existing accounting and reporting requirements, which at this time could have a significant impact on local authorities.
12. If these Regulations are not implemented there will be significant pressure placed upon local authorities to find additional revenue resources within the next financial year in order to comply with accounting requirements.

## **Options**

### Option 1: Do Nothing

13. This could entail authorities diverting allocated revenue resources away from future programmes in order to deal with accounting requirements. For existing premiums, discounts and soft loans this would be very unfair. It could be argued that authorities

entering into these arrangements did so without the benefit of knowing revised accounting standards were to be brought forward. Local Authorities in Wales would be disadvantaged compared to in respect of Local Authorities in England where similar legislation is being brought into effect. Also, effective Treasury management activities are likely to be constrained.

14. Regarding the back pay regulation this option again will put unnecessary pressure on authorities to earmark funds at this point when negotiations are at a sensitive stage with those involved in settling this matter. Again, revenue resources would need to be found immediately when in fact the situation and financing of any back pay arrears are not specifically known at this time.

#### Option 2: Make the Legislation

15. This option would assist local authorities. Without the implementation of these Regulations local authorities will be under pressure to find revenue resources immediately in order to comply with accounting Regulations.

#### **Benefits**

16. The main benefit to local authorities is in the way that they can spread the costs of refinancing loans arising from restructuring their debt portfolios. Local Authorities in Wales hold over £40m of premiums on their balance sheets at this time. Without the ability to spread this cost over a forward period they would need to identify revenue now rather than spread this cost over a forward period. Similarly, local authorities will be able to take a more measured approach in addressing the complex and sensitive negotiations underlying the back pay arrears issues.

#### **Costs**

17. There are no additional costs for the Assembly as a result of these Regulations.
18. There may be a small impact on local authorities in terms of additional calculations in order to comply with the requirements of the Regulations. However, not making these Regulations would have a substantial impact on local authorities' revenue accounts in the financial year 1 April 2007 and would also impact their ability to effectively manage their treasury management function.
19. There are no financial implications for the wider business sector as a result of these Regulations.
20. These Regulations have no specific impact on the voluntary sector. However, an indirect impact could arise as a result of authorities re-examining whether they can continue to provide loans to third parties at a reduced or nil interest rate, if they are required to charge a higher rate of interest to their revenue accounts, in line with revised accounting practice.

#### **Consultation**

##### With Stakeholders

21. The Assembly held a 4-week consultation on the main policy and a further separate 2-week consultation for the additional regulation related to back pay arrears provisions, from 19 December 2006 to 23 January 2007. The Welsh Local Government Association (WLGA) was asked to confirm that this was a reasonable approach and they were supportive of this. The consultations took place with local authorities and

other interested parties and a list of stakeholders is attached at Annex A to the Regulatory Appraisal.

22. The Regulations were broadly accepted as helpful by all respondents, excepting the Wales Audit Office who had some reservations regarding the general principal that accounting requirement should be followed, although they did acknowledge and indicate understanding as to why the Regulations were being brought forward. There were 16 responses to the initial consultation and 9 from the second. Responses were received from local authorities, the Wales Audit Office and the WLGA and a summary of the responses along with the changes made to the Regulations are attached at Annex B to the Regulatory Appraisal.
23. The most significant issue not covered in the draft Regulations during the consultation related to the treatment of “stepped loans” under the revised accounting arrangements from 2007-08. It was acknowledged that these are legitimate concerns, which will be considered and addressed in the next financial year.

#### With Subject Committee

24. These Regulations were notified to the Local Government and Public Services Committee, via the list of forthcoming legislation, on 21 September 2006 (LGPS(2)-12-06 (p.3) item no: LG.099), and have remained on the list ever since. The Regulations were not identified for detailed scrutiny.

#### **Review**

25. The current regulations have now been in operation since April 2004. Since then the efficacy of the existing Regulatory framework and supporting mechanisms has been kept under review by Welsh Assembly Government officials, and whenever appropriate discussed and considered further with the Welsh Local Government Association and local authorities in relevant joint working groups.

#### **Summary**

26. In summary, these Regulations are necessary so that certain aspects of the regulatory regime operated in Wales, is in line with policy intention. In effect changes to accounting requirements would have a disproportionate impact on local authorities' ability to operate effectively and cause them unnecessarily to earmark revenue resources and thereby limit operational effectiveness if the Regulations do not come forward.

## **Annex A – List of Stakeholders**

### Stakeholders

Chief Executives of 22 Unitary Authorities  
Directors of Finance for 22 Unitary Authorities  
Chief Police Officers Welsh Police Authorities  
Directors of Finance Welsh Police Authorities  
Chief Fire Officers Welsh Fire Authorities  
Directors of Finance Welsh Fire Authorities  
Chief Officers National Park Authorities  
CIPFA (Wales)  
Wales Local Government Association  
Wales Audit Office  
One Voice Wales

## Annex B – Summary of Consultation Responses

### Premiums / Discounts and Soft Loans

1. There were 16 respondents to this part of the consultation. Generally all of the respondents either supported or strongly supported the main thrust of the proposed Regulations. The one exception was the Wales Audit Office (WAO) who acknowledged the rationale for the Regulations but pointed to inconsistency between LA and UK GAAP accounting principles as a result. There were a number of additional suggestions, which were reasonably consistent and mentioned by a number of authorities and WAO. These are as follows:-
  - Request that “stepped loan” financial instruments be included in the proposed regulations (6 of the 16 respondents asked specifically). For these financial instruments, although there is no premium or discount to be funded as such, the requirements of SORP/FRS26 will require authorities to recalculate interest chargeable to revenue accounts, averaging this over the life of a loan. For some authorities there may be a one-off bottom line hit for loans of this type already held on balance sheets. This matter is likely to be considered again in the next financial year. This is in line with the approach taken in England.
  - Five authorities and the WAO suggested parity of treatment, between premiums and discounts in general terms. The suggested Regulations allow the premium charges to be funded within a range of possibilities in the Council Fund; where a cash discount is received the proposed Regulations require this benefit to be realised either over the remaining period of the loan or a maximum period of 10 years i.e. the benefit cannot be taken all in the first year. On balance it was considered sensible to avoid the situation that the benefit of a discount was taken fully to a revenue account at the time it is received and yet premiums charges reflected in revenue accounts over a number of years into the future. The compromise position was thought to be a reasonable compromise.
  - Suggestion that treatment of premiums / discounts between the Council Fund and Housing Revenue Account should be synchronised. Currently Housing policy in Wales and England require premiums and discounts to be dealt with within a maximum 10 year period. This is a matter for Housing Policy and has an impact on the timing of payments of Housing Revenue Account subsidy. Whilst there were suggestions as to parity of treatment between the HRA and Council Fund none suggested that the additional flexibility afforded to premiums be forgone and the parity be in line with that applied to discounts i.e. charges to revenue accounts over a maximum period of 10 years. Again the regulations as drafted are a reasonable compromise.
2. Drafting changes to the Regulations have been incorporated following evaluation of the consultation suggestions as follows:
  - to cater for notional premium and discount adjustments where these are implicit within the terms and condition of the replacement loan;
  - allowing for the situation where replacement loan is made up of various components with different repayment periods rather than swapping one single loan with another;

- to allow some flexibility in the definition of “replacement loan” in the Regulations to allow for difficulties in identifying specifically, which loan is being replaced; and
- a change to ensure that any authority who took a discount in full in previous years does not to restate their accounts at the start of the next financial year.

#### Back Pay arrears following Unequal Pay

3. There were 9 responses to this part of the consultation. All of the local authority responses were supportive. The Wales Audit Office again noted the regulation and pointed to the fact that this goes against UK GAAP accounting principles. One respondent made a valid point concerning inclusion of a wider definition of back pay to include employer’s taxation. An amendment to the Regulation was also made to incorporate this.

Respondent / Date rec'd	Summary of Consultation Comments - Initial Consultation: Premiums, Discounts and Soft Loans
Conwy CBC - 10/11/06	Supports the introduction of the draft regulation. No specific comments.
Pembrokeshire County Council	<p>Premia / Discounts – support the principle as in the draft regulations. Would prefer, on an exceptional basis, to allow the <u>possibility for discounts to be taken to Revenue in year one</u> and not as currently proposed.</p> <p>Suggestion that SORP requirements imposed by CIPFA may make accounting and reporting more difficult in respect of calculation of loan interest (stepped loans?). If possible would like further regulation to dis-apply SORP to smooth this process, which could lead to bottom line / budgeting impacts and to an extent constraining effective treasury management (currently the SORP is still out for QA).</p>
Cardiff Council – 16/11/2006	<p>Raised question regarding flexibility of treatment of amortisation of Premia (i.e. suggested that there should be more than two ways to approach this i.e. over period of existing or replacement loan).</p> <p>Suggests that regulation could cover Lender Option Buyer Option (<u>LOBO's</u>) / <u>Stepped Loan debt, which on rescheduling does not generate a Premia or Discount but results in additional charges to revenue.</u></p> <p>Request that Discount treatment should match that of Premia.</p> <p><u>Suggestion that the HRA determination and these amending regulations ensure Premia and Discounts are treated consistently.</u></p>
Blaenau Gwent CBC – 8/12/2006	Generally welcome the regulations. However, they are disappointed that they <u>do not include stepped LOBO loans, which will impact the bottom line</u> for existing and any new loans of this type going forward.
SW Fire and Rescue Service – 5/12/2006	Proposed regulations are welcomed.
Swansea City and County – 6/12/2006	<p>Support the proposed regulations to allow for spreading of Premia / Discounts providing it is prudent to do so.</p> <p>Suggest that the ability to spread the using up <u>of discounts over a longer period than the maximum 10 years</u> should also be allowed.</p> <p><u>Suggestion that wording of the regulation is changed to cater for refinancing where a Premia/Discount is not immediately payable but a replacement loan taken out at a later time results in a “notional premia/discount.</u></p> <p><u>Wording change to regulation to cater for delay between taking out a replacement loan and</u></p>



Respondent / Date rec'd	Summary of Consultation Comments - Initial Consultation: Premiums, Discounts and Soft Loans
	<u>paying off of the original.</u>
Flintshire County Council – 7/12/2006	Fully welcome the proposed regulations. Point out there is a difference in treatment re Premia and discounts and between the Council Fund and HRA, although no opinion is expressed.
Mid & West Wales Fire and Rescue Service – 7/12/2006	Support proposed regulations.
Blaenau Gwent CBC – 8/12/2006	Agree the proposed regulations in respect of Premia/Discounts and Soft loans. <u>Are disappointed that the regulations do not address the interest impact arising from FRS26 on “stepped LOBO’s”.</u>
Wales Audit Office - 11/12/2006	<p>Agree that to bring forward regulations to mitigate the effects of FRS26 in respect of Premia and Discounts, in particular to enable effective treasury management is justified. However, it is noted that this will put LA accounting at variance with UK GAAP accounting principles.</p> <p>In terms of the treatment of Premia – it is suggested that the regulation should not be as flexible and the suggestion is that premia should <u>not be allowed to be amortised further than the life of the existing loan.</u></p> <p>It is noted that there is a difference of approach between <u>Premiums and Discounts</u> and it is felt that there is justification to ensure a <u>consistent approach</u> to their treatment.</p> <p>The opportunity could be taken to re-examine the <u>difference of approach to Premiums and Discounts</u> that currently is in place <u>between the Council Fund and the HRA.</u></p>
Bridgend CBC – 11/12/2006	<p>Suggest that <u>Regulation 4 be amended to say “when Premiums become chargeable” rather than as drafted i.e. “payable”.</u></p> <p>Request that Stepped Loans are addressed via regulations. Mention of up to £3.5m charge to revenue in 2007-08 of these Premiums held on balance sheet are not covered under the draft regulations.</p>
Caerphilly CBC – 11/12/2006	<p>Generally supportive of the intent of the regulations.</p> <p>In Caerphilly’s case they currently take Premia and Discounts to revenue in the year they arise – i.e. follow the SORP. Suggest that a <u>more flexible approach is one, which allows the SORP or regulations to be followed as an authority thinks best.</u></p>

<b>Respondent / Date rec'd</b>	<b>Summary of Consultation Comments - Initial Consultation: Premiums, Discounts and Soft Loans</b>
	<p>The regulations are <u>not consistently applied between Premia and Discounts</u> – would prefer that they were.</p> <p><u>Consistency with the HRA should be addressed.</u></p> <p><u>Stepped Loans / LOBO's would be beneficial if they could be included.</u></p>
Wrexham CBC – 11/12/2006	<p>Premiums – strongly support the regulations.</p> <p>Discounts – consider there should be <u>consistency with the Premia.</u></p> <p>For both Premia and discounts – would like <u>consistency with the HRAS determination.</u></p> <p>Support regulations in respect of Loans below market rates.</p> <p>Stepped loans: requested clarification – will these be included in regulations.</p>
North Wales Police Authority – 11/12/2006	<p>Welcomed proposals. Mentioned that additional comments from Treasury management advisors who raised “a number of small issues”, but these were not forwarded.</p>
Torfaen CBC – 11/12/2006	<p>Welcome proposed regulations.</p> <p><u>Would wish stepped loans are brought within the remit of the regulations.</u> They have indicated that there will be a “bottom line” hit on revenue if they are not.</p>
Rhondda Cynon Taff CBC	<p>Welcome the intent of the new regulations.</p> <p><u>Would like to see synchronicity between the HRA determination and the new regulation.</u> There is a 10 year limit factored into Premia and Discounts.</p> <p><u>Ideally would like Discounts to be treated the same was as Premiums.</u></p> <p><u>Request that stepped loans be brought within the scope of these regulations both for existing stepped loans and going forward: post 1/4/07.</u> Although Premia / Discounts are not applicable there will still be a bottom line hit for some authorities when stepped loans are re-measured following implementation of FRS26.</p>
<b>Respondent / Date rec'd</b>	<b>Summary of Consultation Comments Second Consultation: Back Pay Arrears</b>
Conwy CBC – 10/1/07	<p>Fully support the aim of the regulation.</p> <p>Questioned whether the regulation should be expanded to incorporate any additional costs arising from the Job Evaluation process running alongside of the Back Pay compensation.</p>
Ceredigion 11/1/07	<p>Welcome and agree the proposed change.</p> <p>Suggested the regulation need to be explicit that the back pay arrears would cover employers'</p>

	taxation and superannuation costs.
Wales Audit Office 22/1/07	Note the rationale behind the regulation but do not support the regulation itself, which would otherwise compromise authority accounts in being compliant with UK generally Accepted Accounting Practices. Whilst they agree that the regulation will defer earmarking of funding until the time at which the arrears are paid they concluded that the value of the back pay will still need to be noted in the Income and Expenditure account and dealt with to neutralise the financial impact in the "Statement of Movements" account at year end accounts. They suggest that this could be specifically reflected in the regulation. Additionally a suggestion is made to broaden the scope of the regulation if it goes forward to take account of the possible revenue impact of the Job Evaluation aspect of the single Status exercise.
Flintshire 22/1/07	Fully supportive of the proposed changes.
WLGA 22/1/07	Supports the proposed changes.
Caerphilly 17/1/07	Proposed amendment is entirely reasonable – council is happy to support it.
Vale of Glamorgan 22/1/07	Assumes the proposed regulation includes both the effects of Back Pay and Job evaluation.
Swansea County 18/1/07	Fully support the draft regulation.
Society of Welsh Treasures	SWT very much welcome the proposed changes – particularly they feel that disclosing these amounts may not be helpful as negotiation proceeds.