The Chartered Institute of Public Finance & Accountancy

Ministry of Housing, Communities and Local Government

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

A response by:

The Chartered Institute of Public Finance and Accountancy

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the people in public finance

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

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1. Introduction

1.1 CIPFA welcomes the opportunity to comment on the consultation on mitigating the impact of fair value movements on pooled investment funds on local authority budget setting.

1.2 CIPFA would note that the consultation documents do not include relevant amended extracts of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 so as such it is difficult to give a definitive view on all issues. We would therefore note that these are comments on the principles outlined in the consultation paper. We would be more than happy to meet with MHCLG representatives to discuss the detailed amendments to the regulations.

2. Holdings in Pooled Funds

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?

2.1 CIPFA supports the need for a statutory override and particularly one which deals with the transitional impact on local authorities with pooled investments.

2.2 We would note that it is likely that many (though not necessarily all) pooled investment vehicles would under the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code's) adoption of IFRS 9 *Financial Instruments* fall to be classified as fair value through profit and loss (FVPL). This is supported by the consultations which CIPFA and CIPFA/LASAAC have undertaken.

2.3 CIPFA would comment that some respondents to the consultations on the Code have indicated that they would consider using the option in IFRS 9 to designate these financial instruments to fair value through other comprehensive income (FVOCI). However, we think that this accounting policy choice should be limited to strategic investments. This is particularly the case because once an entity has chosen to designate such instruments then the fair value gains and losses are not (ever) recycled through the Surplus or Deficit on the Provision of Services. This we would consider to be a less transparent means of reporting the full financial performance and impact of these financial instruments even though IFRS 9 does impose a substantial disclosure regime around this designation choice.

2.4 CIPFA/LASAAC has acknowledged that in accordance with the aims of the standard, fair value gains and losses should be reported transparently, fairly and consistently with all other public sector accounting entities in the UK and overseas (applying full IFRS).

2.5 CIPFA both supports and recognises the importance of the transparency provided by IFRS 9. However, it is of the view that there are two immediate difficulties for local authorities. Firstly, it is important that the impact of unrealised losses or gains should not affect the taxpayer through actual reduction or increases in the council's reserves; and secondly, clearly, councils both traditionally and culturally treat the instruments[1] under discussion as investments where the movements are managed until derecognition or disposal on the balance sheet.

2.6 We also note the recent Public Accounts Committee[2] recommendation in its report on financial sustainability in local authorities that:

'*The Department should introduce a statutory override for the requirement under IFRS 9 for local authorities to account for gains and losses from investments in their general funds, in order to prevent any distorting effects on local government financial management*.'

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?

Should the statutory override be time limited?

2.7 This is a difficult issue. We understand that local authorities find investments in the pooled investment vehicles useful instruments, particularly in a period of low interest rates. Our feedback accords with the comments in the MHCLG consultation paper that these forms of investment are viewed as a safe alternative investment to bank deposits and are often used by local authorities as a way to manage cash efficiently. We consider that such investments should be undertaken in a balanced, risk managed portfolio of investments and under the investment principles outlined in CIPFA's Treasury Management Code[3].

2.8 The time limitation might suggest that MHCLG wishes authorities to change their practices over the next three years, but the consultation paper does not clearly indicate whether this would mean that authorities should stop using the relevant investments or to establish procedures to manage the bottom-line impact of the movements in fair value. In either case the perverse incentives towards riskier strategies referred to in the MHCLG consultation paper would still exist after the time limited period.

2.9 In addition, we would note that although the FVPL classification did pre-exist the introduction of IFRS 9, we understand that this was not substantially used by local authorities (with the exception of local authority pension funds). We would also note that it is not normally the case in local government financial reporting that unrealised gains and losses are recognised in General Fund Balances, with the exception of debtors and creditors arising in the ordinary course of an authority's business. There are also risks that fair value gains caused by any windfall movements might in themselves destabilise the General Fund as such gains can be followed by losses in future years which would call into question local authorities ability

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[1] Those financial instruments which were previously classified as available-for-sale.

[2] Public Accounts Committee Report on Financial Sustainability of Local Authorities

[3] *Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes,* CIPFA December 2017

to treat these balances as usable reserves. Additionally, local authorities are unique in the public sector in that they themselves are tax setting bodies and there is a risk that this would add volatility to council tax and housing rent setting on an annual basis.

2.10 There is also the risk that if the statutory override is time limited, local authorities will choose to opt immediately (on 1 April 2019) for the designation we refer to in paragraph 2.3 in the anticipation of the end of the time limited period.

2.11 On balance therefore CIPFA considers that to be consistent with the treatment of other transactions in local authority financial reporting it would be useful if this statutory override was permanent and that gains and losses on these financial instruments should only be recognised against the General Fund on derecognition of the instrument, with fair value movements being recognised in the Financial Instruments Adjustment Account until derecognition. CIPFA would also note that the transparency afforded by the Standard is not lost as the gains and losses would still be recognised in the Surplus or Deficit on the Provision of Services (although we recognise that this would result in an additional statutory adjustment).

How Long Should the Time Limit Be?

2.12 Although CIPFA would on balance prefer that there is not a time limit to the statutory override, a time limited period would allow local authorities to a certain degree to manage the implementation of the standard by permitting local authorities to accumulate an appropriate level of reserves to manage the impact of any accrued fair value losses on financial instruments on the initial application of the standard.

2.13 What is not clear is whether this time period would be sufficient to ensure that local authorities could continue to invest in these financial instruments as a part of the balanced portfolio. We refer to in paragraph 2.7 above and whether such an approach would mean that local authorities would have to change their treasury management investment decisions and practices to accommodate the volatility of the fair value movements. We consider that to ensure that local authorities have enough time to consider the whole of their investment portfolio, plan for such changes and to ensure that there are not any adverse market reaction to the change (some stakeholders have informally commented that they are concerned about the impact on the market), that if there has to be a time limit imposed, the time limited period should be extended to five years.

Detailed Commentary

2.14 CIPFA appreciates that MHCLG issued its consultation document on a principles basis but the consultation document refers to:

'…*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'*.

We are not precisely clear on what this means. We assume that to maintain the status quo during the time limited period the MHCLG's intention is that the override would only apply until the disposal or derecognition of the investments as currently the fair value movements on such funds would impact on General Fund Balances on derecognition. We anticipate that government will make this clear in the amended regulations.

2.15 CIPFA would also wish to understand the precise mechanism of the statutory override in maintaining the status quo. Will MHCLG require that for consistency that both fair value gains and losses will not impact on General Fund Balances? We would also be interested in the mechanism MHCLG wishes to use following the time limited treatment; will all previous gains and losses immediately be repatriated to General Fund Balances, for example? We would be more than happy to discuss the detailed treatment with MHCLG colleagues.

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?

2.16 CIPFA understands from the consultation processes it has undertaken that the financial reporting impact of the adoption of IFRS 9 could also apply to other pooled investment funds and is therefore of the view that similar issues could arise for those funds as well. CIPFA would therefore recommend all pooled investment funds that would be classified under IFRS 9 as FVPL should be considered for the statutory overrides as this would also avoid any market disruptions. We would note that we are aware that some pooled investment vehicles may continue to be classified as amortised cost and would not consider that these financial instruments need to be subject to the statutory override.

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.

2.17 We consider that the fair value movements would be managed in the Financial Instruments Adjustment Account in the same way as other such movements are accommodated in local authority statements of account. CIPFA is of the view that all material transactions should be clearly identified in the financial statements of local authorities. This should be covered by provisions already in the Code (see Code 2018/19 paragraph 3.4.2.67). The Code would also reflect the impact of any statutory provisions once enacted.

3. Earlier recognition of impairments on loans and trade receivables

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.

3.1 CIPFA and CIPFA/LASAAC have undertaken a number of consultative processes and the majority of respondents have appeared to conclude that in relation to the treasury management investments held by local authorities, the impact of the new requirements should be minimal due to the low risk and secure nature of the instruments that local authorities participate in and therefore there should not be a case for statutory overrides. However, CIPFA would be happy to discuss this in more detail with MHCLG if the consultation process identifies any substantial pattern of the expected credit loss impairment provisions having an impact on General Fund Balances.

3.2 CIPFA would note that this is with the exception of those loans made to other parties, for example, for service provision issues, where the need to ensure that the service continues to be provided might mean that these financial instruments are substantially impaired. In such instances the expected credit loss impairment model will properly report the financial impact of the decisions made by the authority. If these instruments have a substantial financial effect on General Fund Balances on an authority the authority will be able to address such issues on an individual basis by means of the normal channels with MHCLG.

4. Disclosure Requirements under IFRS 9

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

4.1 CIPFA/LASAAC consulted on the disclosure requirements under IFRS 9 and the majority of respondents agreed with the approach set out in the consultation papers ie the Code should not include those disclosures that rarely apply to local authorities. CIPFA recognises that the adoption of the standard has the potential to increase the disclosure requirements for local authorities. We are of the view that local authorities should ensure that they only include disclosures in their financial statements where the transactions are material and that local authorities should avoid including too much detail in the financial statements to ensure that the key messages in the financial statements are not obscured.

Other Issues Relating to IFRS 9

4.2 MHCLG is aware that CIPFA/LASAAC is currently consulting on the *Amendments to IFRS 9: Prepayment Features with Negative Compensation*[4]. The amendments to IFRS 9 confirm that most modifications of financial liabilities that do not result in derecognition will result in immediate recognition of a gain or loss. This is likely to mean a change in

[4] See the consultation on the 2019/20 Code for further details.

accounting practice for local authorities with such transactions and will mean remeasurement of the amortised cost balances for these transactions. The CIPFA Local Authority Accounting Panel is considering the issue which may already be covered by the statutory provisions on premiums and discounts but CIPFA will keep MHCLG updated on whether or not there will be a new impact on General Fund Balances.

5. Other Changes to the Capital Finance and Accounting Regulations

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.

5.1 CIPFA considers that this proposal maintains the current position and therefore is content with the extension.

6. Application of the Regulations

Q8: 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?

6.1 CIPFA considers that as IFRS 9 is adopted for the 2018/19 financial year then the statutory override should apply to the same time period for consistency and to ensure that local authority accounts preparers can understand the full financial impact of the standard on the financial statements and particularly on General Fund Balances. The transitional impact of the adoption of the standards (particularly the loss of the Available-for-Sale Reserve) is one of the most important issues for local authorities with a substantial balance as of 31 March 2018. This might include a favourable balance which as is noted in our response to question 2 (see paragraph 2.9), a positive General Fund Balance movement in itself may destabilise the General Fund if this is followed by future losses which would call into question the useable nature of such reserves.

6.2 MHCLG will be aware that CIPFA/LASAAC has spent substantial time considering the impact of IFRS 9 on local authorities and is committed to supporting the Government and the devolved administrations with their consideration of statutory mitigation. MHCLG will be aware that in its Feedback Statement on the 2018/19 Code[5] CIPFA/LASAAC commented:

'*CIPFA/LASAAC will continue to be open to new evidence and will keep the position under review to assess whether any new actions might need to be taken in the form of an update to the 2018/19 Code if, for example, the statutory mitigation outlined in paragraph 14 was subject to a delay*.'

[5] file:///C:/Users/SarahS/Downloads/Technical_Information_Note_18_01_Final_2_for_issue%20(7).pdf