

# Public Expenditure System

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## CENTRAL GOVERNMENT LENDING AT COMMERCIAL RATES OF INTEREST

### Introduction

This paper provides guidance to Departments on the implementation of the policy that central government lending (from the National Loans Fund (NLF) and from Voted loans) to public sector bodies competing commercially should be at a commercial rate, which will be higher than the standard NLF rate. It should be read in conjunction with Chapter 25 of *Government Accounting*.

2. PES (2001) 5 is intended for use by the Treasury, sponsor Departments and public sector bodies and Departments are asked to alert them to it.

### Summary

3. Central government lending to commercial bodies in the public sector, which are for a significant proportion of their business competing against private sector companies in the market, should be at a rate which is comparable to the commercial rate that would be charged to a comparably-sized company operating in a similar commercial environment in the private sector, on the basis of a credit rating which excludes any explicit or implicit government guarantee.

4. Central government lending includes lending from the National Loans Fund (NLF) and Departmental lending from Votes.

5. This new policy will apply for **new loans** taken out after 1 February 2001, and to investments which have already been made on the express understanding that their funding will be through borrowing subject to this policy. Otherwise, pre-existing loans will continue on the terms and conditions that applied when they were taken out.

### *Why introduce a new commercial lending policy?*

6. Previous policy was that central government lending to public sector bodies should be at a rate which reflects the cost of government borrowing, including administration costs. Such lending is at better rates than public sector bodies could obtain directly from the private capital market since the government is able to command more favourable borrowing terms.

7. The new policy is that commercial public enterprises in competitive markets should continue to borrow from central funds (whether from the NLF or from the Vote) but should pay a market rate for such loans. The interest rate charged on such borrowing will reflect the enterprise's own creditworthiness, specifically excluding any implicit or explicit government guarantee.

8. The objectives for introducing this new commercial lending policy are twofold:

- to ensure that public sector bodies facing direct private sector competition in the UK and / or internationally are exposed to similar financial disciplines (eg commercial borrowing rates) as their private sector counterparts as far as this is possible, ie create a level playing field amongst all competitors; and
- to deliver best value for money for the public sector, and in turn the taxpayer.

9. To allow these bodies to borrow direct from the private capital markets instead would not achieve these two objectives because: (i) the markets would regard such borrowing as being underwritten (at least implicitly) by government, and so such borrowing is likely to confer little, if any, additional discipline; and (ii) it would forego value to the public sector, ie the margin above the low rate at which central government can raise funds to lend.

10. Charging public sector bodies that compete commercially a commercial rate for borrowing from central government will:

- give comfort to competitors that there is no implicit government subsidy since enterprises operating in a competitive market will not receive preferential terms for their borrowing;
- remove the possible risk of challenge on the basis that such lending is an illegal state aid;
- help to reinforce commercial disciplines on the management of public sector bodies operating in commercial markets;
- reinforce the Required Rate of Return (RRR) for public sector bodies set out in *Investment Appraisal in the Public Sector* (the "Green Book"). This regime ensures that public sector bodies set prices in order to achieve an agreed rate of return on capital employed by the activity as a whole before tax and financing costs. The new commercial lending policy reinforces the rate of return requirement by ensuring that the body faces a commercial cost of capital; and
- continue to offer value for money to the public sector as a whole since the money is raised at the low rate available to central government.

### ***What powers are HMT using to apply this policy?***

11. Subsection (6) of section 5 of the National Loans Act of 1968, as amended by the Finance Acts of 1982 and 1983, provides that the Treasury in determining a rate of interest may take into account any consideration justifying a rate higher than the rate sufficient to avoid lending at a loss from the NLF. In the light of its legal advice, the Treasury has concluded that the importance of this policy will amount to justification within the subsection, provided it is applied in a fair, reasonable and consistent manner. Higher rates would in particular be justified where they were required in order to avoid unlawful State Aid.

12. The rate of interest charged on central government lending from Votes is referenced to NLF rates and as such the same policy will apply.

### ***How to apply the new commercial lending policy***

13. The following guidelines will be used to determine whether an enterprise is operating in a competitive market:

(i) bodies, or their major subsidiaries, which compete with the private sector for a significant majority (over 75 per cent) of their business (measured by turnover) would automatically fall within the new lending policy;

(ii) bodies which compete with the private sector for between 20 and 75 per cent of their business would be subject to consideration on a case by case basis;

(iii) bodies which compete with the private sector for less than 20 per cent of their business are likely to fall outside the scope of the new policy, although the purpose of the loan would have to be assessed against the discrete activity condition (iv) below to ensure that this part of their business did not represent a significant competing service in that particular market;

(iv) bodies which seek finance for a particular, discrete activity that would compete with the private sector would be subject to consideration on a case by case basis but would usually be expected to fall within the scope of the policy.

14. Departments will be responsible for identifying any public bodies whose borrowing might fall within the guidelines. It is important that Departments notify the Treasury of any borrowing that may fall within the scope of this new policy at the earliest opportunity (see also [Annex A](#) which is also available in [pdf format](#)). They should consult, in the first instance, with the relevant Treasury spending team. The following procedure would ensue:

- the Treasury will discuss with the Department before deciding whether or not the body did need to borrow at a commercial

rate. This process will include consultation with the DTI's State Aid policy unit;

- if so, the Department will then need to obtain independent financial advice on:

**(i) the appropriate credit rating** - the rating should be based on the assumption that the body in question has no guarantee from government, whether explicit or implicit (eg through public ownership). Once this has been done for the first time, the credit rating can be reviewed annually by the Department, for example as part of the body's corporate planning process.

**(ii) the corresponding interest rate payable for each loan** - this should take into account market conditions and appropriate benchmarks in the bond and other debt markets. Where a range of possible interest rates appear in the market, advice should err on the side of prudence.

- On the basis of this detailed advice and any other relevant information, the Treasury (the Debt and Reserves Management Team, involving the Debt Management Office) would then carry out its own checks and set the rate under the National Loans Act 1968, and authorise it by a formal Treasury Minute. For NLF lending, the Treasury spending team also needs to send to the Treasury's Exchequer Funds and Accounts team: (i) a signed instruction to issue the loan on the terms and date specified; (ii) the Department's written request for the approval of the loan; (iii) the body's request for the loan; and (iv) the body's Borrowing Certificate.

15. There will be a trade-off between the cost of obtaining independent advice and the scale of the investment being undertaken. In cases where the cost of obtaining advice on the credit rating is disproportionate to the scale of the investment (eg one off loans involving small sums or of short maturities), the Treasury will set a rate on the basis of a single A rating.

16. The Treasury can provide advice to Departments on the appointment of advisers and likely fees. Any such appointment would be expected to follow normal guidelines on procurement. In the first instance, Departments should contact their relevant spending team in good time, who will consult other teams within the Treasury as required.

17. It is for Departments to decide who will bear the cost of the financial advice, in discussion with the body concerned. The Department may wish to bear the cost of advice to retain ownership and to ensure high quality output.

18. Other aspects relating to policy and guidance on central government borrowing will remain in place. Such details are provided in Government Accounting, for example, the application of normal rules on premature repayment of NLF loans, prior notification and Treasury consent.

### ***Borrowing at variable rates***

19. Borrowers required to borrow at commercial rates will usually borrow on fixed rate terms. Consideration of variable rate lending will be on a case by case basis. If borrowers wanted to borrow on variable rate terms, they would need to demonstrate the business need to the Treasury. If approved, repayments on variable rate loans can be made monthly, quarterly, or half-yearly when the loan is rolled over. At each rollover date a new interest rate will be set to take account of changes in short term rates.

### ***Borrowing in foreign currency***

20. In some circumstances public bodies may wish to borrow to finance a project or an acquisition in a currency other than sterling. This might be in order to hedge against exchange rate risk, where the future expected income stream from the investment will be in a currency other than sterling. In these circumstances the public body would usually be expected, if it has the expertise, to borrow in sterling from the NLF and then undertake a foreign currency swap. This would be subject to the body (or its subsidiaries) having the requisite statutory powers to undertake foreign currency borrowing and currency swaps.

### ***Accounting for borrowing at commercial rates under RAB***

21. This policy has no implications for the scoring of expenditure under RAB.

### ***Who might this commercial lending policy apply to?***

22. This policy will apply to loans from central government, and to the following groups of public sector bodies.

### **Public Corporations**

23. We would expect public corporations which provide monopoly services and do not operate in competitive markets to fall outside the scope of the new lending policy. However companies (and their subsidiaries) such as the Post Office which increasingly operate in competitive markets are likely to fall within the new regime.

24. In cases where a public corporation is the subject of a future significant share sale which involves a substantial transfer of risk and responsibility to the private sector, then the general presumption will be that borrowing prior to the public private partnership (PPP) will fall within the new regime, but borrowing post PPP will be directly from the private capital markets whether the PPP involves a minority or a majority share sale. The Treasury will consider exceptions to this treatment on a case by case basis and on its commercial merits, for example in the case of non-recourse financing for projects, or where direct access to the debt capital markets would be a useful precursor to wider injection of private capital.

### **Trading Funds**

25. Most Trading Funds (TFs) are financed by means of Voted loans through their sponsor department and not directly by the NLF. Many TFs supply statutory monopoly services and so any lending to them would be unaffected by this new policy. However, the new lending policy would, in principle, apply to any TF which competes with the private sector to a significant degree.

#### **Non-Departmental Public Bodies (NDPBs)**

26. Whilst, in practice, the amount of borrowing by NDPBs may not be significant (most are financed by grant-in-aid), this policy will apply to them, but subject also to them satisfying the borrowing conditions set out in Chapter 5 of Cabinet Office guidance on “Non-Departmental Public Bodies: A Guide for Departments,” March 2000. These conditions include: NDPBs having “significant receipts,” ie over half its expenditure is met from revenue; and having provisions for loan finance in the statute under which the NDPB operates.

#### **Action required by Departments**

27. Departments will need to determine which of the bodies under their sponsorship fall within the scope of this lending policy and to keep this under annual review.

#### **General**

28. Electronic versions of PES Papers issued this year, including this one, may be found at: [www.hm-treasury.gsi.gov.uk/psd/pespaper/pespaper.htm](http://www.hm-treasury.gsi.gov.uk/psd/pespaper/pespaper.htm). Information on PES Papers can be obtained by telephoning 020 7270 5525.