The Chartered Institute of Public Finance & Accountancy

Welsh Government Consultation on the Statutory Guidance on Local Authority investments

September 2019

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30 September 2019

Judith Cole
Deputy Director, Local Government Finance and Workforce Partnerships Division
Cathays Park,
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Dear Judith

Response to the Welsh Government Consultation on the Statutory Guidance on Local Authority investments

1. Introduction

1.1 CIPFA is very grateful for the opportunity to respond to the consultation. For ease of reference, the commentaries in this response follow the order of the consultation document, as far as possible.

1.2 We also welcome acknowledgement of CIPFA's role in the Prudential Framework in Wales.

1.3 As is acknowledged in your covering letter Welsh Government is also aware that there has been some substantial activity with a relatively small number of authorities that have invested in commercial properties.

1.4 Although not a Welsh issue CIPFA would note that Gareth Davies Comptroller and Auditor General for the National Audit Office commented at 'Public Finance Live' that commercial investments in the acquisition of land and existing buildings had increased nearly four-fold between 2010-11 and 2017-18, to more than £3.5bn. He also noted that around 80% of the activity has come from 20% of local authorities. We do not think that the same level of activity in this area exists in Wales but we agree that the Statutory Investment Guidance should still address this issue.

1.5 CIPFA holds the same position as the Welsh Government as is set out in paragraph 45 of the Prudential Code ie that:

Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.

The Welsh Government is aware that CIPFA has been working on guidance to assist local authorities in this area in relation to commercial properties. On 16 September 2019 CIPFA's Public Financial Management Board (PFMB) has approved Prudential Property Investment guidance for issue. Our publications team is in the process of getting this publication ready for issue but in the meantime please find attached the version approved by PFMB.

1.6 As noted above CIPFA is of the view that the issue highlighted in the Welsh Government covering letter relating to local authorities investing in commercial properties is not a substantial issue in Wales. At the same time CIPFA is not perfectly clear what the objective of some of the changes to the statutory guidance might be and is concerned that they might inadvertently encourage the types of investment that we think the changes are intended to discourage. We would be more than happy to discuss this in more detail.

1.6 In order to assist Welsh Government colleagues we have also noted some minor typographical type errors which we have included in a short Appendix.

2. Guidance on Local Government Investments

2.1 CIPFA generally supports the need for the production of an Investment Strategy. However, we would raise the following points on the draft Guidance on Local Government Investments (the Investment Guidance):

Investment Strategy – Purpose and Publication

2.2 The new guidance does not appear to provide an overview of the purpose of the Investment Strategy, currently specified in paragraph 4.2 of the 2010 edition of the guidance. This would be helpful to authorities, enable them to understand the context and where local authorities combine the Investment Strategy with other publications (see point 2.3 below) ensure that they position the Strategy effectively for local authority members and other stakeholders.

2.3 CIPFA agrees with the proposal that where a local authority prepares a Capital Strategy the matters to be disclosed in an Investment Strategy can be included in that document as the function of a Capital Strategy in CIPFA's updated Prudential Code is to *'set out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes'.*

Power to Invest

2.4 With regard to paragraph 22, we consider that generally local authorities will invest prudently in order to support the services that they provide. Some of those services may not be deemed to be 'core' functions and may still be provided by the authority in accordance with its strategic objectives.

CIPFA, however, agrees with a comment that was highlighted during our consultation processes relating to the CIPFA Prudential Property Investment guidance referred to above ie local authorities have a much larger role within their communities than solely being service providers (though CIPFA acknowledges the importance of being a service provider). An example of this would be local authorities' well-being powers.

We recommend therefore that paragraph 22 should refer to a local authority's other powers and duties, for example, by referring to local authorities as serving the public and promoting the well-being of their local communities. This is similar to the approach the Welsh Government has taken in paragraph 25.

Classification

2.5 We would note that the classification in paragraph 23 does not accord with the approach that CIPFA has taken in relation to our Prudential Property Investment guidance. We identified two categories of investment based on the legal powers in section 12 of the Local Government Act 2003 ie

- investments relevant to a local authority's functions, and
- investments held for the prudent management of an authority's financial affairs.

We do not think that it would be helpful to encourage the understanding that there might legitimately be a third category of investments with a speculative, commercial nature.

2.6 CIPFA acknowledges and agrees with the addition of paragraph 27 in relation to the need to disclose to what extent investment decisions consider long-term climate risk to support a low carbon economy. We consider, however, that local authorities may need guidance in relation to how to achieve and report this.

Non-financial Investments

2.7 CIPFA is concerned about the commentary made in paragraph 33. CIPFA would note that this paragraph appears to be at odds with paragraph 49 which accords with CIPFA's position that local authorities may not borrow in advance of their need purely in order to profit from the investment of sums borrowed, as this paragraph refers to non-financial investments held either primarily or partially to generate a profit. CIPFA recognises that some non-financial investments for service or other powers of the authority may have a commercial/profit making elements but is concerned that without appropriate caveats this paragraph currently appears to conflict with paragraph 49.

2.8 With regard to the last sentence on paragraph 33 CIPFA is of the view that a substantial proportion of non-financial investments may be investment properties. The last sentence of paragraph 33 sets out that '*Such assets will not normally be subject to minimum revenue provision'*. This appears to contradict paragraph 32 of the Welsh Government Statutory Guidance on the Minimum Revenue Provision which states that the '*duty to make MRP extends to investment properties where their acquisition has been partially or fully funded by an increase in borrowing or credit arrangements'*.

Security, Liquidity and Yield

2.9 CIPFA concurs with the comments in paragraph 38 that the Prudential Code sets out clearly that the prime policy objective of local authorities' treasury management investment activities is the security of funds, and they should avoid exposing public funds to inappropriate or unquantified risk.

2.10 We would note that the previous edition of the statutory guidance established a preference between security and liquidity and then clearly prioritised these concepts before yield. We understand that this was particularly important to governments across the UK following the failure of Icelandic banks in 2008. The new guidance does not appear to express a preference for security over liquidity. Although Icelandic banks are referred to in the covering letter. CIPFA is keen to understand whether this is a policy change for Welsh Government.

2.11 Paragraphs 39 to 41 are concerned that local authorities both understand and manage the risks that emanate from the need to ensure that there is security in the fair values of any non-financial investments held by the authority and that these are properly reported in a local authority's Investment Strategy so that they are understood by elected members and other stakeholders. However, we note that the reporting triggers are:

i) when the fair value of an investment property is no longer sufficient to provide security against loss, and

ii) where a local authority recognises a loss in the financial statements.

CIPFA very much supports the overall aims of the Welsh Government. Indeed CIPFA's guidance on Prudential Property Investment covers the risks that might face a local authority in some detail. However, CIPFA would comment that it may be worthwhile ensuring that the practical issues are addressed in the statutory guidance. For example, as drafted the reporting triggers for both will happen when the investment property fair value is insufficient to protect against loss or when fair value losses occur and these triggers could be effected when the amounts in question might be as little as a penny.

CIPFA would recommend that some consideration of materiality as understood by proper (accounting) practices should be included. In addition, CIPFA would recommend that the guidance considers the need to assess all the risks included in such investments. In any informal guidance which usually accompanies the investment guidance CIPFA would recommend that Welsh Government refers to the CIPFA guidance on Prudential Property Investment. CIPFA would be more than happy to discuss the informal commentary with the Welsh Government.

2.12 We would note that non-financial assets (investments) are by their nature not liquid investments and that local authorities will have different objectives for these investments. We are therefore not clear how local authorities can ensure that they meet the objectives in paragraph 43, second sentence. As is stated by paragraph 43, this issue will be subject to market conditions which although we recognise should be reasonably active for investment properties and other non-financial investments will still be subject to the vagaries of the market and the need to maximise the income from the sale. We would note that although we are aware of an acceleration in the acquisition of investment properties in England in recent years but that for numerous authorities including Welsh authorities these are legacy investments.

2.13 CIPFA would seek to understand what the Welsh government intends in relation to the first sentence of paragraph 45. An uninformed read of this sentence might consider that this promotes an approach where a local authority considers becoming 'totally' dependent on this form of income, which is unlikely to be prudent. We suggest that this sentence be amended to reflect that there are income streams which contribute to the calculation of the budget requirement for council tax setting purposes.

2.14 We note that paragraph 46 refers to the need to assess the dependence on profit generating and borrowing capacity over the term of the medium-term financial plan. CIPFA agrees with this provision. However, we are concerned about the last sentence of paragraph 46 which only 'recommends' an assessment of the long-term risks.

CIPFA would question this guidance and is of the view that while it is vital that local authorities understand the impact of local authorities' investments in commercial activities in the medium-term financial plan, it is also important, in line with the principles set out in paragraph 21, that local authorities understand the impact of such investments over their term, to ensure that there is long-term affordability and financial sustainability/resilience relating to these investments (though CIPFA would acknowledge that some of the more detailed financial assessments in the medium-term financial plan would not be possible in the very long-term).

Investment of Money Borrowed

2.15 In accordance with our introductory comments CIPFA very much concurs with the position in paragraph 49 in relation to borrowing in advance of need. CIPFA would fully agree with the Welsh Government's comments that the practice of some authorities (though not, we understand, as yet, a substantial practice in Wales) of local authorities borrowing to invest in properties where there are substantial commercial returns will put a strain on the Prudential Framework (and indeed the Prudential Code sets out that local authorities must not do this). CIPFA wonders whether the commentary in paragraph 50 is though appropriate for inclusion in statutory guidance and this commentary might be better placed in the informal commentary which usually accompanies the guidance.

2.16 CIPFA understands the rationale for the inclusion of paragraph 51 in the statutory guidance. However, we would caution against the inclusion of these reporting requirements as paragraph 51 is contradictory to the establishment of the principle in paragraph 49 and appears to include an immediate acceptance that the statutory guidance and the Prudential Code can be disregarded. This has been an area of debate where there are similar provisions in the English guidance. CIPFA acknowledges the status of the statutory guidance and the Prudential Code and that local authorities are required to 'have regard' to these elements of the Prudential Framework but is of the view that this paragraph needs to be carefully worded to maintain the needs of the framework and the other statutory provisions in the Local Government Act 2003.

2.17 The flexibilities of the Prudential Framework require local authorities to 'have regard' to the statutory guidance and allow local authority to take their own decisions on borrowing and investment. We would note, however, that the statement in paragraph 45 of the Prudential Code (replicated in the draft statutory investment guidance) is based on CIPFA's interpretation of statutory provisions in the framework established by the Local Government Act 2003 – see Appendix A in our guidance on Prudential Property Investment. So local authorities should not be able to 'explain' why they have overridden any of the legal requirements of the Framework as this is a part of their adherence to their statutory duties under the Act. We would therefore recommend that paragraph 51 is drafted along the following lines:

> *Where a local authority, after having regard to the provisions in this guidance and the CIPFA Prudential Code, decides to depart from any of the explicit provisions of those publications, it will still need to ensure that it meets the requirements of the powers and duties afforded by Chapter 1 of the Local Government Act 2003. Additionally it should:*
>
> *i) identify the legal powers to support the proposed transactions*
>
> *ii) demonstrate that the exercise of those powers is reasonable*
>
> *iii) explain in accordance with paragraph 45 of the Prudential Code when an authority borrows in advance of need how it can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds*
>
> *iv) confirm that the authority wishes to proceed with the approval of full council.*

Capacity, Skills and Culture

2.18 We would note that in relation to the disclosure requirements for capacity, skills and culture that the requirements in the Prudential Code for a Capital Strategy includes:

> '*a summary of the knowledge and skills available to the authority and confirmation that these are commensurate with the authority's risk appetite*.'

We consider therefore that this issue is covered by the requirements for the production of a Capital Strategy.

CIPFA is more than happy to discuss this response or any aspect of the Statutory Invest Guidance with Welsh Government. If you have any queries on this response please contact Sarah Sheen:

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CIPFA

Yours sincerely,

Don Peebles
Head of CIPFA Policy & Technical UK

Appendix

Minor Corrections

Reference	Suggested Edit
Paragraph 27	We wonder whether Welsh government meant to say ‘long-term climate risks’ rather than ‘long-term and climate risk’ as this paragraph is discussing supporting a low carbon economy rather than long-term reporting of investments and acquisitions.
Paragraph 33	We suggest that reference to ‘physical asset’ be replaced with ‘ physical asset or assets’
Paragraph 48	We suggest that the word ‘what’ is deleted from the text before the colon to ensure that the sentence flows into the bulleted list items.