**CIPFA Draft Guidance – Prudential Property Investment**

**SDCT Response**

**Overview**

The SDCT agrees that additional guidance would be helpful to support local authorities, and particularly S151 Officers, through what is a complex process to ensure that they are acting in a correct manner. However, SDCT is of the view that the document is too long and overly prescriptive which may lead to unintended consequences. The document is also contradictory in places which may place S151 in difficult situations when advising their authorities on strategic decisions involving prudential borrowing. The length of the document is a concern as the shorter it is, the more likely it is be read and understood. The key points need to be made clearer so that the reader can find them quickly.

A clearer definition of ‘borrowing in advance of need’ is required along with clarification on the application of S120 of the Local Government Act 1972 which permits local authorities to buy properties outside of their area.

SDCT would also question the data that is being relied on when putting this guidance together – what is the scale of the problem that the guidance is attempting to solve?

The following response details our concerns with the draft guidance and the Society is happy to meet with CIPFA colleagues to discuss further.

District Council Funding

Local authorities **and district councils in particular**, require new and innovative income streams to enable them to continue to deliver statutory services to the high standard required by the public.

Many district councils no longer receive any RSG with negative RSG still a possibility in one form or another. Business Rates Retention remains uncertain for the short term and even more so in the long term. The resetting of the Business Rates System will have a significant financial impact to authorities but particularly to those districts who have delivered significant growth – the FFR increases the financial uncertainty authorities face. Council tax referendum limits continue to restrict the ability to obtain extra income and many service income streams (e.g. planning) are restricted by centrally set fees or increases. Many authorities have reviewed how their services are delivered and realigned services, however you can only reduce costs so far. This has meant authorities have looked to other income streams which are a necessity if district councils are to continue to operate successfully and property investment is one area that many have gone into. Other options include doing nothing which inevitably leads to cutting services. Such an approach is not sustainable in the long term and clearly reduces the level of services provided by the sector.

It should be remembered that local authorities have invested in property for many years, this is not new to the Sector. However, there has clearly been an increase in property acquisitions for the reasons outlined above. The continuation of reduced levels of funding from local government has led to local authorities wanting to become more self-sufficient, commercial investments enable the risks to be managed at a local level rather than having to react to ongoing reductions in government funding. It is an authority’s responsibility and that of the s151 Officer to ensure the necessary due diligence has been undertaken prior to making a commercial investment.

This situation is reflected in the following CIPFA statement on 03/07/19:

The majority of local government finance officers have lost confidence in their future financial positions over the last year, a CIPFA survey has revealed.

Seventy per cent of respondents said they were either slightly less or much less confident in their financial position this year compared to 2018-19, according to the CIPFA’s confidence survey out today.

Rob Whiteman, CIPFA chief executive, said: “Local government is facing greater demand pressures than ever before, with particularly pressures in adults’ and children’s social care and housing. Local authorities also lack certainty about their future financial positions, so it’s unsurprising to see confidence on the decline.

“We have repeatedly pointed out that local government is in need of a sustainable funding solution, but meeting this demand requires more than pennies and pounds. The sector as a whole must come together to address the challenges of effective service delivery.”

The draft CIPFA Guidance does not reflect this view, particularly in the foreword.

The guidance should accept that local authorities may need to increase risk levels to enable them to deliver public services as other funding sources have reduced or disappeared. **It takes property investment in isolation without accepting the real position that local authorities are currently in.**

Doing nothing as we approach the cliff edge is easy to do from a compliance perspective but s151 officers need to find solutions to divert away from the cliff edge and the current guidance does not give many options and this document is proposing to reduce them further without providing alternatives.

Property Investment

The guidance does recognise the risks involved in property investment and it would be more useful to recommend levels of due diligence required and what this should include when making decisions and how they fit in to certain powers. Then s151 officers would be trying to work within CIPFA Guidance rather than trying to work around it.

The guidance is attempting to fit property investment in to current legislation when that is not what it was originally intended for. Ideally new legislation should be produced that addresses the real current issues.

Should the Prudential Code continue to say 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”? If it has to be explained what that really means, then it is no longer fit for purpose.

Local authorities need to work together to share best practice and learn from each other’s experiences. CIPFA should be a conduit for this and the guidance should encourage this. In the long-term, property acquisitions should increase the strength of the public sector balance sheet and help contribute to maintaining service delivery.

**The key points are:**

1. State clearly if CIPFA’s view is that authorities should not borrow to fund investment properties where that involves capital expenditure. The draft guidance does not make this clear and is contradictory in parts.
2. Then also clearly state the exceptions with greater clarity as this is currently likely to result in conflicting legal opinions.
3. If legal opinion does conflict with this guidance, s151 officers may be put in a difficult position with colleagues and members regarding whether a scheme can take place or not. As an example, S120 of the Local Government Finance Act 1972 contains the following provision:

120 Acquisition of land by agreement by principal councils.**E+W**

(1) For the purposes of—

(a) any of their functions under this or any other enactment, or

(b) the benefit, improvement or development of their area,

**a principal council may acquire by agreement any land, whether situated inside or outside their area**

The very last part of this provision appears to contradict with the tone of the guidance and the implications for borrowing for commercial property outside of the local authority area.

1. The key points in the guidance need to be highlighted and easy to find to help make it a user-friendly document.
2. The specific considerations that should be addressed before an authority undertakes a commercial venture (generally a property purchase) need to be clearer, unambiguous and concise. The guidance has a tone that is more rhetorical than would be ideal, often commenting negatively on a particular course of action but then seeming to state “but there again”.   Such an approach does leave s151 Officers in a difficult position because of all of the different shades of colour that pertain to various courses of action in respect of property purchase are present.
3. The guidance needs to be much clearer as to which legal powers it is not comfortable with when they are used for property purchases.  Annex A lists many of the legal powers but causes quite a lot of confusion when clarifying whether a property purchase is a treasury management investment or whether it is a non-treasury management investment.   The section on internal borrowing seems to be somewhat misleading.  Temporary surpluses of working capital/cashflow are not the determining factor when identifying specifically what type of investment a property purchase may be.  Local authorities have an important role to play here, in that they too must be clear and unambiguous in the phrasing they use for reporting, when the primary purpose of a non-treasury management investment property purchase is driven by economic regeneration reasons but may also deliver a commercial return.  The guidance must therefore also be clear that such schemes are still acceptable if the appropriate rigour has been applied in the capital appraisal of such schemes.
4. The guidance must provide further clarity in its use of the term “borrowing in advance of need”.   The wording in the Prudential Code is clear and is related to borrowing in excess of the Capital Financing Requirement (or Underlying Borrowing Requirement if netting off PFI scheme debt and finance leases).  Trying to then give this specific phrasing a second meaning by referring to borrowing that should not be used for the purchase of commercial assets is not helpful.   In fact, that logic is flawed as authorities only identify a holistic approach to funding their capital programmes in their Treasury Management Strategy Statement and Treasury Outturn Reports, and borrowing for a particular scheme is only true in the sense that borrowing is allocated to a particular asset for MRP purposes.  In any event, all financial appraisals of capital projects/schemes should be using a robust, consistent approach that entails a cost of capital assumption.   A scheme should not progress, or be put on the backburner, just because alternative funding is available other than borrowing e.g. capital receipts.  We agree that the source of the funding for the advancement of a particular capital scheme should not be a key driver unless it is tied to significant funding provision by e.g. government capital grant/development contribution.
5. The reference to the Wednesbury Principles of reasonableness is not new.  With regard to emphasising Security, Liquidity, Yield in taking investment decisions, s151 Officers have been doing that since the advent of the Treasury Management and Prudential Codes.   However, CIPFA’s focus on the acquisition of commercial property and proportionality emphasises their concern in relation to non-treasury management related investments.   Nonetheless, those investments will generally rely on separate powers to those pertaining to the day to day treasury management investment of surplus cash and, so, CIPFA needs to be clear if it is specifically referring to capital expenditure activity based on separate powers, such as LGA 2003 or the Localism Act, and that the capacity, skills and culture element of a broader capital investment decision making process has to be properly recorded, embedded and actioned.  To that end, CIPFA’s recent work on the Capital Strategy, Financial Resilience Index and Financial Management Code should all inter-link to help aid this process in a joined-up manner, and although we would concur that the draft CIPFA guidance should be shorter and more concise it would be sensible not to overlook developments in respect of governance, scrutiny and resilience that are running in parallel.
6. A clearer definition of ‘borrowing to invest’ is required.
7. Push for changes to legislation that relate to current practices rather than trying to fit them in to current legislation (which was not written with property investment in mind).

**Comments on Specific Paragraphs**

Foreword

General: further clarity is required on exactly what type of investment are included in this guidance as some sections could easily be taken out of context. The Foreword refers to ‘all’ local authority investments.

Para 2 (part in bold): There needs to be a clear definition as to what this means as it is key to the rest of the document.

Para 3: “this applies to all forms of investments.” This results in added complications. The guidance needs to be as simple as possible to focus on the important points rather than touch on associated issues. This results in the guidance being long and the key points difficult to find.

Para 5: this approach should be taken for all property purchases, not just those for investment purposes.

Para 7: This is what s151 officers do so does not need to be reiterated. **Borrowing to invest requires a clearer definition as you can borrow to invest for economic development schemes as well as pure investment only schemes.**

Summary

Para 2: This needs more explanation as authorities have always been able to borrow to buy property.

Para 4: “extends to all acquisitions of land and/or buildings.” Again, the guidance is more complicated than it needs to be, it should just focus on borrowing for investment. There needs to be some differentiation here between the types of commercial investment that are being undertaken.

Para 7: “Here consideration must be given as to whether investments can only be made with surplus cash already available to an authority or whether it can generate the necessary surplus cash by borrowing”. The purpose of this sentence is unclear.

Para 8: CIPFA’s view is a challenging statement as s151 officers cannot take property investment in isolation. It is part of a wider strategy to ensure the ongoing financial sustainability of each authority.

Para 8: The Prudential Code requires an acquisition to be proportional – the level of due diligence carried out to reduce the ongoing risks can change the proportion that is acceptable. Our view is that most commercial property investments still fit within the Prudential Code guidance and so the need for this additional guidance is unclear.

Part 1 - Introduction

Para 6: Clarification is required as to what is a “substantial consideration” to apply the guidance.

Part 2

The guidance emphasises the requirement to obtain a view on legal power and the use of borrowing to support acquisitions of commercial property.  There is a diagram that makes it clear that if S.12 Investment Power is used then borrowing should not be taken to support the activity. This means it has to be supported by cash (reserves, balances, provisions etc.) but such an approach would run the risk of converting revenue to capital as any proceeds from the sale of the capital asset would be classified as capital receipts.   We believe that there are few local authorities that are specifically looking to rely on s12 Investment powers for the purpose of buying capital assets, but there are some, and we would suggest that if Counsel opinions are providing inconsistent (or alternative) advice this could be an area that CIPFA seeks some uniformity.

Para 11: This could jeopardise local development. It needs to be clear about what is included.

Para 14: The interpretation by the guidance would potentially impact the activities of some local authorities who seek to rely on a legal opinion.

Para 14: it would be useful to define “substantial speculative elements”. Again, this is where risk and due diligence impact as they should remove the speculative elements.

Para 15: This paragraph is concerning. It would be better to change the way CFR is calculated rather than via a guidance note.

Part 3

Para 19: “This does not mean that the provisions in the guidance are mandatory.” **This is a major point and should be included in the Foreword (preferably after the statement in bold in para 2). This suggests that if you have a reasoned argument you can still do it.** This will result in legal advice being obtained to allow a scheme to take place and will leave the s151 officer in potential conflict with other officers.

Para 23: The point above also relates to this paragraph.

Para 24 (bullet 2): This point could be made used to show that income from investment provides funding to deliver services.

Para 24 (bullet 6): This point is contradictory to the parts of the guidance that state borrowing for activity purely to generate a profit is unlawful.

Para 28: The guidance makes comment around the on-going costs of managing property purchases and the need for sufficient on-going scrutiny of outcomes/performance.  This could potentially be an area overlooked by some authorities when putting such schemes forward for member approval, but one would expect evidence of due diligence, picking up and commenting on such factors, to be available before a scheme progresses.

Para 36: These are obvious points so do not add any value. This part could be deleted to ensure the guidance is set at the right level.

Para 49: This is extreme prudence rather than just prudence. It should recognise that there are risks.

Part 4

Para 57: This statement is clear that authorities should not borrow to invest, but there are exceptions shown elsewhere in the guidance.

Para 62: This suggests that authorities can borrow to invest and so contradicts para 57. This needs to be put in stronger terms in the foreword. CIPFA guidance is that it should not be done, but if authorities do, they are required to have certain things in place. This again, is likely to put the s151 officer in a dilemma.

Annex A

A1-8: In respect of powers to acquire property, we acknowledge that these are issues that may be best left to lawyers but the only concern with that is that they won’t necessarily link it to the Capital Financing Requirement, borrowing and other day to day Treasury Management factors. They may just say this power can be used to *acquire* and if it is *a function* then an authority has the power to borrow under S.1.

A19-22: The guidance is inconsistent when discussing borrowing in advance of need in that it seems to focus on the old definition which was set out in the Secretary of State Investment Guidance and, whilst we agree with CIPFA’s thought process, we need to point out that MHCLG removed that definition in the 2018 version of the Investment Guidance and replaced it with the following:

***Borrowing in advance of need***

*46. 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.*

*47.  Where a local authority chooses to disregard the Prudential Code and this Guidance and borrows or has borrowed purely to profit from the investment of the extra sums borrowed the Strategy should explain:*

*• Why the local authority has decided not to have regard to this Guidance or to the Prudential Code in this instance; and*

*• The local authority’s policies in investing the money borrowed, including management of the risks, for example, of not achieving the desired profit or borrowing costs increasing.*

There has been confusion about what the revised borrowing in advance of need paragraph means and whilst we agree that the previous definition was very useful and provided something which set out clear guidance it has changed, and the guidance may want to consider that point before the document is released.  The revised MHCLG guidance also removed reference that it related to investment under the S.12 power and have included references to items that are expenditure.  Again, this has been addressed in A23 to A29 and, whilst the guidance makes some very good arguments, it still accepts that any decision of use of powers would ultimately sit with the Courts when, in fact, clarity is required.

A25: See comment on Part 2 Para 14 above regarding “substantial speculative elements”.

There is reference in the ITC to internal borrowing.  For example, in Annex A A33, the guidance seems to imply it is legitimate to externalise an internal borrowing position to provide cash to acquire commercial property.  This is something of a *red herring*.  Internal borrowing is simply a strategic and temporary under-borrowing position, vis-à-vis the historic capital financing requirement, facilitated by surplus working capital/cashflow and cash backed reserves and balances.  It, therefore, follows that if new commercial activity does not result in an increase in the capital financing requirement it must mean it isn’t capital expenditure and would, therefore, be an investment under S.12.

Furthermore, in the diagram it exemplifies a £100m CFR that pertains to previous capital expenditure which was not fully funded.  The authority in the example has taken £95m external loans and £5m internal loans. All things being equal, they still have a potential £5m of their balance sheet resource available to invest (e.g. Reserves/Balances/Provisions/Capital Receipts/Grants Unapplied) with counterparties. If they externalise the residual £5m internal borrowing with external loans the Capital Financing Requirement remains at £100m and external loans will be increased to £100m.  The authority, therefore, only increases the cash available to invest using the S.12 power. It does not create any headroom to fund new capital expenditure.

The SDCT hopes that this response will be fully considered before the final guidance is produced. The SDCT would be open to further discussion to help make this guidance a useful document that will assist s151 officers in carrying out their duties in the correct manner.

**Society of District Council Treasurers**

**24 July 2019**