

**PRUDENTIAL PROPERTY INVESTMENT**

**DRAFT CIPFA GUIDANCE ON THE APPLICATION OF THE  
PRUDENTIAL FRAMEWORK JUNE 2019**

**[EDITION FOR CIRCULATION TO TREASURERS' SOCIETIES]**

## Foreword

Most of the capital expenditure incurred by authorities requires risks to be managed, particularly in relation to whether the assets acquired will provide the benefits projected for them and whether estimates of acquisition and running costings and income generation will be reliable. These considerations will impact on decisions whether it would be prudent to borrow to fund such expenditure.

Reductions in government funding have meant that local authorities have been under growing pressure to incur capital expenditure with the objective of generating revenue income that will compensate for reductions in Government funding. This guidance focusses on the recent concerns which CIPFA shares relating to the rapid expansion of acquisitions of commercial property and its relationship with CIPFA's statement in its Prudential Code 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**. Where authorities exceed the limits of Prudential Code and the wider Prudential Framework this places a strain on the credibility of the Prudential Framework to secure the prudent management of local authority finances.

The view expressed in the Prudential Code effectively reflects the circumstances where there is no specific or projected need to borrow but an opportunity has been identified to make an investment return greater than the authority's cost of borrowing. Although this guidance focusses on commercial properties, this applies to all forms of investment including the acquisition of those properties and financial instruments. For local authorities, who have access to borrowing at relatively low rates, there are tempting opportunities to generate income at no net capital or revenue cost.

However, this is not a risk free activity as is set out in this guidance:

- All decisions to incur expenditure and to borrow must be backed by effective legal powers, which might not be available. There is an additional problem in that these might subsequently be invalidated by changes in statutory provisions or developments in case law.
- The authority's returns (income and capital gains) are at risk, while, once incurred, borrowing costs are unavoidable. A reduction in returns could put the authority's revenue account into deficit. Both this guidance and the government's statutory investment guidance raise the issue of risks in relation to the fair value of the property on the balance sheet, for example, where the commercial property fair value is less than the value of the debt liability.
- Assuming the investment is purchased at market prices, the extra margin or return must reflect additional risk.

CIPFA would contend that the primary function of local authorities is to provide public services, and in doing so they have a fiduciary duty to taxpayers as well as a responsibility to their citizens generally to provide value for money and protect the value of their resources. Local authority treasury management is based on the principle that authorities should take relatively low risks when investing public money. All local authority investments, including commercial property, must comply with these basic principles of prudence in the management of public money.

An investment into commercial property is far more likely to meet the needs of the Prudential Framework where its main purpose is directly to deliver service benefits sufficient to justify the financial risks involved. A local authority should not put public money and services at risk to the extent that an investment bank or commercial investor may legitimately do with their shareholders' funds. The authority's Chief Finance Officer must be alert to these risks and advise accordingly before, during and after investment decision-making.

The guidance (including the Annexes) which follow explore the technical and legal issues in detail, and this is complex territory. However, Section 151 officers should focus their authorities on the underlying fundamentals of proposed investments, and not rely on technical presentation in considering whether they are "borrowing to invest" contrary to both government and Prudential Code guidance.

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## Summary

Over the last five years there has been a growing trend for authorities to acquire land and buildings with the effect of supplementing their revenue budgets with rental income. Often these acquisitions have been supported by borrowing cheaply from the Public Works Loan Board (PWLB).

Questions have been asked about how these transactions fit with the guidance that has traditionally been given that borrowing to make an investment return is not permissible. MHCLG's Statutory Guidance on Local Authority Investments and CIPFA's Prudential Treasury Management codes have all been updated recently to address the implications of investment in property.

The objective of this guidance to explain the provisions in the updated Prudential Code and Framework that relate to the acquisition of properties intended to make investment returns and confirm their implications in the light of the growing activity and the changes to statutory guidance.

The scope of the guidance extends to all acquisitions of land and/or buildings where rental income and/or capital appreciation are a substantial consideration in the decision whether to enter into the transaction. Some of its content will be relevant to decisions to invest generally.

A decision to acquire property intended to make an investment return will have three parts:

- the identification of the legal powers that support the proposed transactions
- demonstration that the exercise of these powers would be reasonable
- confirmation that the authority wishes to take the proposed course of action.

The identification of legal powers will involve the consideration of statutory provisions that facilitate the acquisition of land and/or buildings (the land and buildings route) and the conditions that attach to these provisions. The conditions will in particular need to permit the authority to act commercially and recover more than the cost of providing services through use of the property. Identification of an applicable property acquisition power will usually make borrowing powers available.

Where the conditions for exercising a property acquisition power are not met by a particular proposal, consideration will switch to the powers available to justify making investments (the investments route). 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 distinction between following a land and buildings route or an investments route through the legal powers is therefore crucial to questions about the use of borrowing to fund an acquisition. CIPFA's view is 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.

Once appropriate legal powers have been identified, an authority must be satisfied that their exercise will be reasonable. This will involve:

- consideration of the Wednesbury principles of reasonableness

- regard in making an acquisition and managing the investment to the MHCLG Statutory Guidance on Local Authority Investments, including:
  - its support for the CIPFA view on not borrowing more than or in advance of need
  - the requirements for transparent reporting about the implications of an acquisition for the security, liquidity and proportionality of the investment and the authority's risk exposure
  - the need for appropriate capacity, skills and culture
- regard to the CIPFA Prudential Code, which requires any acquisition to be:
  - affordable – taking into account the extent to which expenses will be covered by income, including any need to make provision for capital expenditure consistently with the MHCLG Statutory Guidance on Minimum Revenue Provision
  - prudent – maximising the reliability of the elements of the affordability analysis and ensuring risk is controllable within acceptable limits
  - proportional – ensuring that the authority's revenue budget is not over-reliant on income from commercial property and that property does not constitute an inappropriate proportion of the overall investment portfolio

Where a proposal to acquire property as an investment is confirmed to be reasonable, an authority will determine whether the plans are consistent with its strategies and policies. Particular attention will be paid to the following areas:

- corporate strategy – managing the expectations of interested parties in relation to the transactions being undertaken
- investment strategy – ensuring that the longer-term nature of property investment and the different balance of security, liquidity and yield fit into the authority's overall strategy for making investments
- property strategy – ensuring that the property can be managed effectively and sustainably
- competence to take effective decisions – ensuring that the experience and expertise available to the authority (internal and external) is robust enough to support decisions about acquisition and continuing management of property and allow appropriate scrutiny.

## **Part 1 – Introduction**

### **Background**

- 1 Local authorities have a long history of holding investments in property in their Balance Sheets. Acquisitions have been made for a wide range of reasons, going back in history beyond the reclamation of Second World War bombsites and including projects relating to urban regeneration, economic development and maintenance of local employment opportunities.
- 2 However, in the last five years there has been an increasing trend for authorities to purchase property solely to make an investment return. Whilst such acquisitions have been an accepted part of the range of investment opportunities for pension funds, for many authorities investing in property will be a new consideration, requiring new approaches to risk assessment and management of exposures. Particular concern has been expressed where authorities have borrowed using their prudential freedoms to fund their acquisitions.
- 3 The increased scale of investment in property was recognised in 2017 by revisions to the CIPFA Prudential Code and the Treasury Management Code. Amendments were made to ensure that non-financial assets which an organisation holds primarily for financial returns were covered comprehensively by the definition of investments and the provisions that apply to them.
- 4 In February 2018, the Government updated its statutory guidance for both local authority investments and minimum revenue provision to address property investments, particularly to give a view that borrowing to acquire investment assets, including commercial property, is unlikely to be prudent.

### **Objective**

- 5 The objective of this guidance is to explain the provisions in the Prudential Code that relate to the acquisition of properties intended to make investment returns and confirm their implications in the light of growing activity and the changes to statutory guidance.

### **Scope**

- 6 The scope of this guidance extends to all acquisitions of land and/or buildings where rental income and/or capital appreciation are a substantial consideration in the decision whether to enter into the transaction.
- 7 This guidance has been written to relate primarily to English local authorities and the references to legislation will be principally for English authorities (though some of the earlier legislative references may apply to other nations). The principles referred to in the guidance which relate to the Prudential Framework, however, are likely to have a UK wide application.

### **Overview of the Structure of the Guidance**

- 8 The following parts of this guidance look in more detail at the decisions that an authority should take before it acquires a commercial property. There are three basic questions that need to be addressed, each of which might actually require complex analysis to determine:

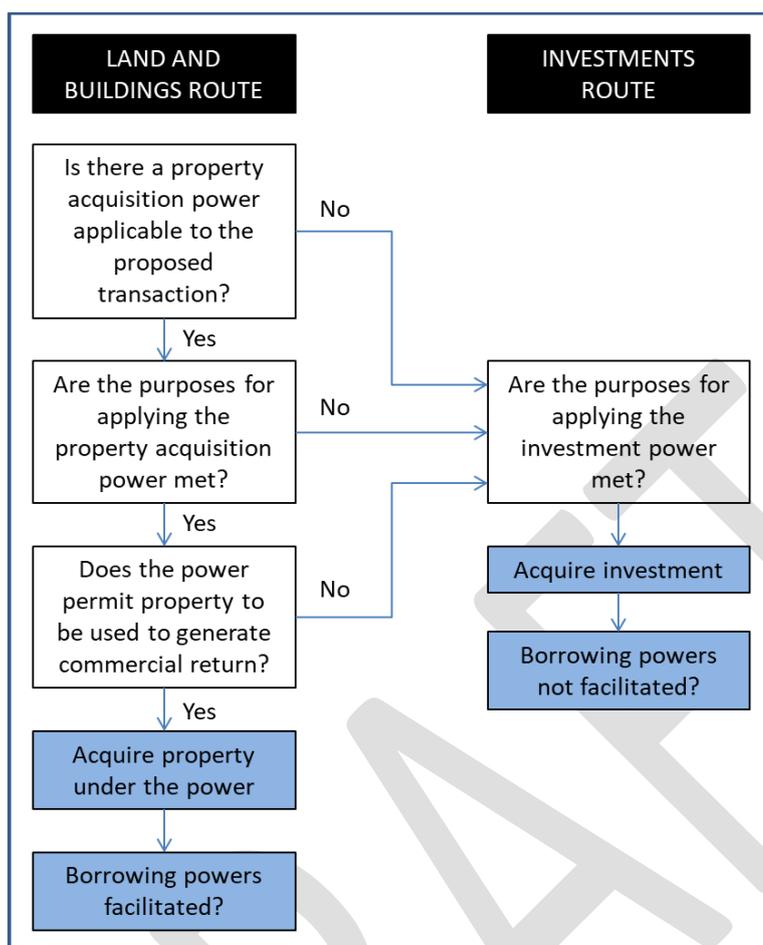
- can we acquire commercial property – see part 2?:

- are there legal powers to support the acquisition and, crucially, are they powers specifically to acquire property or to make investments?
- where borrowing is required, are powers available to support the taking out of loans?
- should we acquire commercial/investment property – see part 3?
  - is it reasonable to exercise the authority's legal powers in the way proposed?
  - do the authority's decisions have proper regard for the statutory guidance?
  - do the authority's decisions have proper regard for the Prudential Code in terms of affordability, prudence and proportionality?
  - is the acquisition defensible under the best value duty?
- will we acquire commercial property – see part 4?
  - is the proposal consistent with the authority's corporate and financial strategies?
  - can the proposal be accommodated within the authority's investment strategy and property strategy?
  - does the authority have the necessary competence to take the proposed decision?
  - does the authority have appropriate skills to manage the asset?

## **Part 2 - Can We Acquire Commercial Property?**

- 9 Any decision taken by a local authority needs to be supported by an effective legal power. Specific legal powers all have restrictions on the circumstances in which they can be applied. Even where use of a general power is proposed, consideration will need to be given to ensuring that it is appropriate to the particular circumstances and that any constraints to or conditions of its application are complied with.
- 10 Acquisitions will need to be supported by legal advice that confirms that powers are available to justify what an authority proposes to do. It is not the role of this guidance to provide such advice, and the rest of this chapter is devoted instead to considering which issues would need to be addressed in comprehensive legal advice.
- 11 It is CIPFA's view (expressed in paragraph 45 of the Prudential Code) 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 justification for this view in relation to investment in property is set out in detail in Annex A and summarised in the following paragraphs.
- 12 Although it might appear a pedantic distinction, it will be significant for determining if borrowing is justified to support investment in property whether an authority can identify an applicable power to acquire land and/or buildings or whether it must seek to rely on powers to invest. It is probable that use of a property acquisition power will facilitate use of borrowing powers, but much less probable that use of an investment power will have the same effect. The distinction is illustrated in the following chart, which shows the implications of the two statutory routes:

## Diagram – Routes for determining Powers to Acquire Commercial Properties



- 13 There is a range of powers permitting the **acquisition of land and buildings**, each with their own conditions as to how the power can be applied. For a commercial property, these conditions would also need to permit the charging of (commercial) rents in order to make a return that would exceed recovery of the costs of providing services through the use of the property. Where a proposal meets these conditions, then the power will be available to justify the acquisition. Identification of an applicable property acquisition power should then qualify the authority to exercise its power to borrow to fund the transaction.
- 14 Circumstances become more problematic where an applicable property acquisition power cannot be identified. In this case, an authority would need to exercise a power permitting the **acquisition of investments**. Section 12 of the Local Government Act 2003 provides general powers to invest for any purpose relevant to an authority's functions and for the purposes of the prudent management of its financial affairs (which should therefore exclude any substantial speculative elements). However, use of this power is complicated if investment is planned to be funded from borrowing:
- It is traditionally the case that on-lending (borrowing to make an investment return) has been regarded as unlawful. Put simply, if an authority wishes to invest, it must do so with its own cash, not someone else's. By this argument, investment powers could only be applied where an authority has generated its own surplus cash through the exercise of its functions and could not be used to justify use of borrowing powers to secure the necessary funds.

- Identification of on-lending is not straightforward where an authority has previously undertaken internal borrowing – applying surplus cash balances to the avoidance of external borrowing rather than the making of investments. Provided it would be prudent to do so, it could be legitimate to externalise this borrowing by taking out loans and investing the surplus cash that has been released as a result.

15 In practical terms, the Capital Financing Requirement (CFR) will indicate if the acquisition of property purely as an investment involves on-lending. This will be the case where the authority's external borrowing would exceed its CFR, after capital expenditure on property acquired under investment powers is deducted from the CFR – see paragraphs A30 to A33 of Annex A.

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## **Part 3 - Should We Acquire Commercial/Investment Property?**

### **Introduction**

- 16 The existence of legal powers is insufficient in itself to justify an authority taking a decision to acquire commercial property (which might meet the definition of an investment property under the financial reporting requirements in the local authority accounting Code<sup>1</sup>). The exercise of powers must be carried out reasonably and in accordance with relevant statutory guidance and professional codes of practice. The legal powers will establish circumstances in which an authority could act, but other considerations will determine whether it should act in the proposed way:
- the application of case law principles concerning the reasonableness of decision-making
  - statutory guidance issued by the Government, to which authorities making particular decisions must have regard
  - the CIPFA Prudential Code, to which authorities must also have regard when making certain decisions
  - good practice in investment management, which considers the appropriateness of investments to the authority's risk appetite, its financial circumstances and the expected length of the investment need (considered further in Part 4).

### **Reasonableness**

- 17 The identification of legal powers is only the first step in ensuring the legality of any proposal to acquire commercial/investment property. The exercise of the powers must be reasonable. Legal advice will therefore need to extend to consideration of Wednesbury principles.
- 18 Support would confirm (or otherwise) the authority's view that decisions:
- have not taken into account matters which ought not to have been taken into account
  - have not refused to take into account or neglected to take into account matters which ought to have been taken into account
  - are not based on conclusions so unreasonable that no reasonable authority could ever have come to them.

### **Statutory Guidance**

- 19 Chapter 1 of the Local Government Act 2003 sets out the statutory underpinning for the Prudential Framework, including in particular the borrowing powers (section 1) and the investment powers (section 12) discussed in Part 2 of this guidance. When carrying out their functions under this Chapter, authorities are required by section 15 of the Act to have regard to guidance issued by the Secretary of State. This does not mean that the provisions in the guidance are mandatory but that they must be considered by an authority and departed from only where a robust and reasonable argument can be put that an alternative approach will meet the authority's various duties under Chapter 1 of the Act.

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<sup>1</sup> Code of Practice on Local Authority Accounting in the United Kingdom

- 20 There are currently two sets of section 15 guidance in effect:
- Statutory Guidance on Local Authority Investments (third edition, 2018) – the Investments Guidance
  - Statutory Guidance on Minimum Revenue Provision (fourth edition, 2018) – the MRP Guidance.
- 21 In February 2018, each of the documents was updated to address the acquisition of commercial/investment property funded by borrowing. The Investments Guidance has the most relevance for decisions about whether an authority should acquire commercial/investment property. Paragraph 46 contains the following statement:
- “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. ”
- 22 Paragraph 34 of the Informal Commentary to the Investments Guidance confirms that this is a restatement of what is said in the Prudential Code (see paragraphs 25 to 51 below), but also sets out clearly that the Government view is the statement extends to cover borrowing taken on to finance the acquisition of non-financial as well as financial investments.
- 23 The Investments Guidance recognises that it cannot prohibit the acquisition of commercial/investment property funded by borrowing, but authorities not following the Prudential Code and the Guidance are expected to provide an explanation in their Investment Strategy. This means that members meeting as a whole will have to endorse the policy, and make it publicly available on the authority’s website. Any decision to acquire commercial/investment property will therefore be influenced by the need for appropriate governance and open reporting. This is reflected in the key principle of transparency and democratic accountability in the updated Investments Guidance.
- 24 The detailed specifications of the Investments Guidance and the associated observations in the Informal Commentary particularly relating to investment property are set out in Annex B. The key issues relevant to decision-making informed by the principles in the Guidance are:
- transparency and democratic accountability – proposals should be compliant with the investment strategy approved in advance by members and made publicly available
  - contribution – authorities should disclose the contribution that investments make towards service delivery objectives and the authority’s placemaking role
  - use of indicators – quantitative indicators are required to allow members and the public to assess the authority’s risk exposure – the particular indicators are at the discretion of authorities, but the Informal Commentary recommends a suite of indicators
  - security – authorities should have a strategy for assessing risk of loss before entering into a transaction and disclose the extent to which the fair value of investment property provides security against loss and the mitigating actions proposed if there is insufficiency – although not specifically discussed in the Statutory Guidance the analysis of security would have to take into account subsequent expenditure needed to maintain the value of a property (as well as acquisition costs) and the extent to which Minimum Revenue Provision has been made

- liquidity – the investment strategy should set out procedures for ensuring that funds invested in property can be accessed when needed
- proportionality – plans to achieve a balanced budget depending on profit-generating investment activity should be disclosed in the investment strategy with detail of the extent of dependency and contingency plans – as part of this, the Informal Commentary expresses a Government view that authorities should not take on debt to acquire investment properties
- borrowing in advance of need – where an authority does not follow the guidance that it is not permissible to borrow more than or in advance of need purely in order to profit from investment of the proceeds, an explanation is needed of why the authority has decided not to have regard to this guidance and the policies for investing the money borrowed
- capacity, skills and culture – the investment strategy should contain steps to ensure that members and officers have appropriate capacity, skills and information to be involved in decision-making.

### **Prudential Code**

- 25 Regulation 2 of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 (SI 2003 no 3146, as amended) specifies that authorities shall have regard to the Prudential Code in complying with their duties to determine an affordable borrowing limit.
- 26 Although regulation 2 might seem to be a restricted duty, in practice it is wide reaching, as it covers all the steps that could reasonably be assumed to be part of assessing what the limit should be, securing member authorisation and monitoring the authority's position against the limit. The Prudential Code will therefore need to be referred to throughout the process, not just at the point the limit is being determined.
- 27 For the acquisition and financing of commercial/ investment properties, the relevant (inter-related) considerations will be:
- affordability
  - prudence
  - proportionality.

Affordability and prudence considerations apply generally to property acquisitions, but have particular implications for investment property. Proportionality is a specific consideration for transactions that have commercial risk.

#### *Affordability*

- 28 In comparison with the treasury investments that authorities make, commercial/investment properties are unusual in that they have ongoing costs. Apart from any initial transaction costs, investments will not normally generate an expense for an authority to the extent that payments due to the authority under the relevant contract will not be forthcoming (eg, a default on the payment of interest or repayment of principal). However, ownership of investment property involves taking on a range of running costs, potentially including:
- maintenance costs

- property taxes
  - letting costs
  - tenant management expenses
  - rent losses on vacancy
  - interest costs in relation to borrowing.
- 29 The affordability analysis for the acquisition and holding of a commercial/investment property will therefore be much more detailed, with a greater probability that professional advice will be needed that will require expertise and experience not typically available to the authority.
- 30 A particular issue for the Prudential Framework will be how the authority meets the cost of capital expenditure incurred in relation to the property. The temptation might be to treat investment property like other types of investment, where the cost of acquiring an instrument would be covered by the amount that the authority expects to receive back on redemption or sale. This treatment is encouraged by the fact that the proper accounting practices for investment property do not involve the charging of depreciation. However, this does not mean that investment properties are effectively costless in relation to acquisition and refurbishment.
- 31 Capital financing can be provided by setting aside usable capital receipts or revenue balances to cover the cost of an investment property, resolving affordability issues. Otherwise, affordability will be assessed by the impact on revenue budgets of Minimum Revenue Provision (MRP) made over the life of the asset. (Note that where revenue resources are applied to meeting costs, these will not be replenished if an asset is sold as the current statutory requirement is for sales proceeds to be reserved as capital receipts.)
- 32 The Statutory Guidance on Minimum Revenue Provision (the MRP Guidance) takes a firm line in this area in paragraph 45:
- 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
  - as depreciation is not charged on investment properties, the Depreciation Method<sup>2</sup> is not a suitable approach for calculating the MRP.
- 33 The expectation of the MRP Guidance is then that the cost of acquiring or constructing an investment property that has not been financed from other resources (eg, capital receipts) will be charged as MRP applying the Asset Life method. The cost will be amortised over a useful life established in accordance with proper accounting practices. However, paragraph 42 of the MRP Guidance caps the useful life to a maximum of 50 years, unless:
- a professional opinion has been given that the asset will deliver service functionality for more than 50 years (not applicable to an investment property)

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<sup>2</sup> Under the Depreciation Method, an amount of MRP is calculated equal to the depreciation charged in any particular year in relation to the relevant asset.

- the asset was acquired under a lease or PFI contract with a term of more than 50 years.
- 34 The Informal Commentary to the MRP Guidance also cautions against refinancing risk. Paragraph 40 sets out concerns that some authorities are programming MRP for investment property over a much longer period than the debt instruments taken out to fund the acquisition. When refinancing falls due, it cannot be guaranteed that PWLB terms of trade will not have changed unfavourably. If so, the authority might need to increase significantly their annual charge to top-up MRP or develop other plans to manage increased liquidity risk on repayment of debt.
- 35 Paragraph 21 of the MRP Guidance does acknowledge that it cannot be prescriptive:
- ... other approaches are not meant to be ruled out, provided that they are fully consistent with the statutory duty to make prudent revenue provision. Authorities must always have regard to the guidance, but having done so, may in some cases consider that a more individually designed MRP approach is justified ... the decision on what is prudent is for the authority and it is not for MHCLG to say in particular cases whether any proposed arrangement is consistent with the statutory duty.
- 36 However, any alternative policy should reflect the facts that:
- investment properties will be subject to wear and tear like any other property held by an authority, even if proper accounting practices do not require depreciation to be accounted for separately
  - the acquisition of an investment property will normally require incurring substantial transaction costs, which proper accounting practices will allow to be capitalised but which would not prudently be carried forward unfinanced indefinitely
  - investment properties are only likely to hold their value if subsequent capital expenditure is incurred to replace components or refurbish the fabric of the building.
- 37 Over time, the capital cost of a building will accumulate and, if there is no systematic basis for financing original and subsequent expenditure, the underlying need to borrow will grow and with it the deemed cost of borrowing attributable to the property. An alternative MRP policy will need to reflect properly the impact that an asset will have on the Capital Financing Requirement over its lifetime and the need to balance the physical depreciation of the building against any appreciation in market value.

#### *Prudence*

- 38 Considerations of prudence will predominantly be based on assessing the reliability of the elements of the affordability analysis and the risk that projections and presumptions could change unfavourably. The focus will be on confirming that there is manageable risk that in any future financial year a deficit might arise on the operation of an investment property that would need to be met from the general revenues of the authority.
- 39 Comparative analysis will also be required against alternative investment opportunities, applying the authority's Investment Strategy in a systematic way to determining whether the possibility of a higher yield would compensate for the reduced security and liquidity.
- 40 Particular considerations will include:

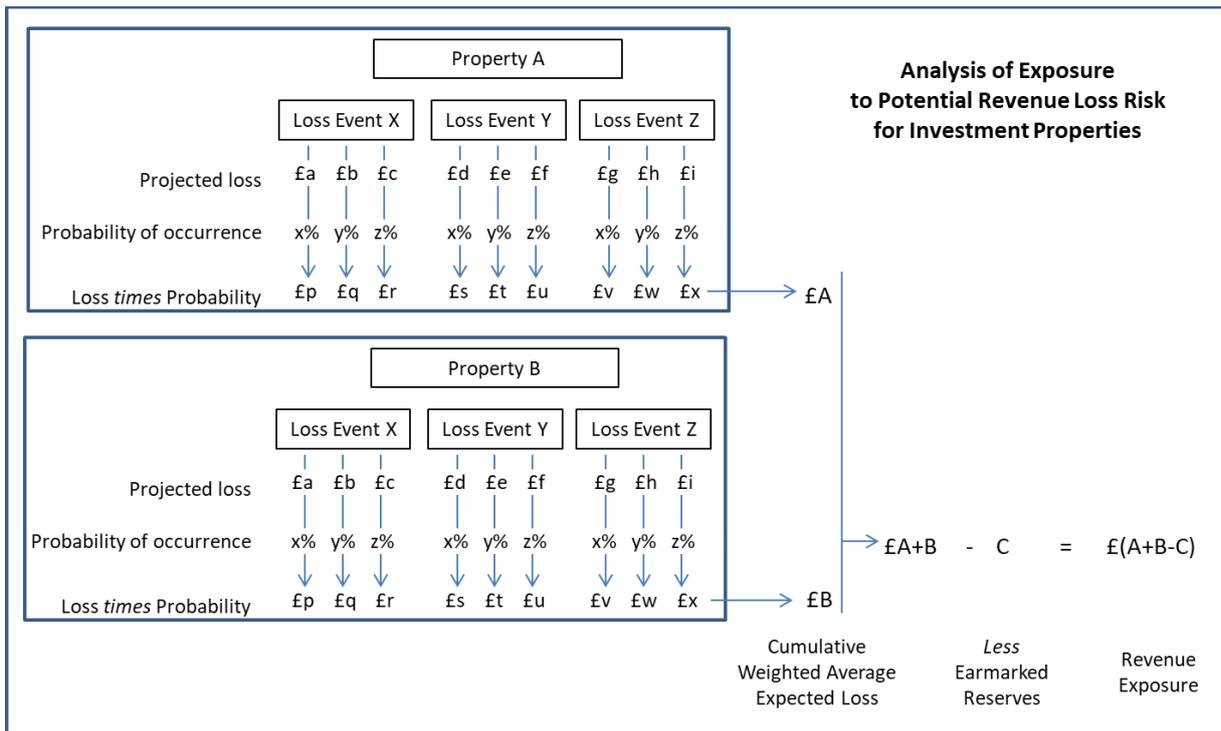
- the sensitivity of projected running costs to price changes and other influences
  - trends in future rent levels
  - the possibility of void periods or defaults on rents due
  - possible costs of having to enforce contractual terms
  - changes in interest rates (including refinancing risk if borrowing is at fixed rates)
  - changes in regulatory environment relating to landlord activities
  - changes in property tax frameworks
  - changes in regulatory arrangements for local government finance.
- 41 A general consideration will be the extent to which the authority is willing to rely on unrealised gains in its stewardship of public funds. The optimistic view might be that in the long-term property price inflation will mean that a building will always be worth more than the authority paid to acquire it and keep in a lettable condition. Proponents of this view would argue that it would be over-prudent to finance these costs whilst they are more than covered by the market value of the property (even though this is a strategy that would mean accepting considerable risk).
- 42 However, the implication of an optimistic policy of avoiding over-prudence is that there will be no grounds for avoiding the immediate financial consequences if the optimism proves unfounded and it becomes prudent to finance expenditure. For instance, if an authority is not following the MRP Statutory Guidance because revaluation gains are anticipated to cover the cost of the property, consistency would require an immediate charge to revenue if:
- the market value fell below the unfinanced capital cost of the property
  - capital expenditure is incurred on the property that does not increase its market value pound for pound.
- 43 Prudent positions also need to recognise the fact that, if an investment property is sold, the sale proceeds will be a capital receipt, restricted to being applied to finance capital expenditure. If a property becomes vacant and rents are no longer receivable, the resultant gap in the revenue budget cannot then be filled by selling the property. The gap will only close to the extent that the capital receipt can generate a return from an alternative investment opportunity. This will also be wholly dependent on the authority being able to sell the property within the required timeframe.
- 44 Consideration of refinancing risk will reflect the authority's overall treasury management policy. If the authority has a maximum borrowing period of, eg, 30 years, the acquisition of a property with a 50 year life might expose the authority to a refinancing risk for the latter 20 years of the useful life of the property that could result in the project becoming unaffordable. The Informal Commentary on the MRP Guidance appears to encourage making MRP over 30 years, effectively removing the borrowing requirement beyond that point. However, there should be other strategies for dealing with such risk, including building contingent amounts into the affordability figures for years 31 to 50 for increased interest costs.

*Proportionality*

- 45 There are two main aspects to proportionality:

- the extent to which the authority's revenue budget is reliant on income from investment property
  - the proportion of the value of the authority's investment portfolio that is made up of investment property (ie, the relative balances of financial and non-financial investments).
- 46 Proportionality for the revenue budget will depend on the risk that the authority is exposed to in relation to its property portfolio. Careful analysis will be required of the maximum amount that the revenue budget could reasonably absorb in any year from shortfalls in rent, unexpected landlord's expenses or revaluation losses that should prudently be covered immediately, taking into account the probability that these events might happen.
- 47 This analysis will need to be adapted to the authority's local circumstances. Compare for instance an authority with a single property occupied under a long-term lease by a company with an effective parent guarantee to an authority owning a shopping centre subject to multiple short-term lets to businesses with challenging trading prospects. These two authorities have very different risk exposures, with the second being exposed to both greater and more diverse risks.
- 48 As a minimum, authorities should follow the recommendations of the Investments Statutory Guidance and set an indicator for the ratio of commercial income to net service expenditure.
- 49 Where the analysis is more complex, the following approach based on weighted average expected losses is recommended:
- identify for each investment property the substantial loss events that could take place in relation to the property (eg, rent default, event requiring catch-up MRP charge) that could have a revenue impact
  - for each loss event, obtain an estimate from an appropriately qualified and experienced person of the range of losses that could arise in any particular year
  - for each projected loss, have an appropriately qualified and experienced person assign a probability that the loss might arise
  - multiply each loss by its probability of occurrence to give an expected loss
  - sum all the expected losses for each event for the property to give the weighted average expected loss
  - sum the weighted average expected loss for all of the authority's investment properties
  - deduct any earmarked reserves from the sum of weighted average expected losses for the investment portfolio
  - compare the resulting figure for revenue exposure to the maximum losses that the revenue budget could reasonably absorb in any year
  - where the weighted average expected loss is greater than the maximum losses, action will be needed to remove or manage the risks so that the revenue exposure is reduced to a proportionate level.

50 This process is exemplified in the following diagram:



- 51 The first step in establishing a prudent position will be to determine the level of earmarked reserves that are to be set aside to provide security for the investment. This will be part of the Chief Finance Officer’s review and report on the adequacy of proposed reserves carried out under section 25 of the Local Government Act 2003.
- 52 Where the revenue exposure is greater than the maximum sustainable loss, steps will need to be taken to limit the losses that might arise or remove or reduce the probability of loss events taking place. Alternatively, earmarked reserves could be increased. If these steps do not reduce the revenue exposure to an acceptable level, consideration will need to be given to disposing of properties.
- 53 Proportionality for the value of investment property as part of the overall investment portfolio will be assessed in the wider strategy for investment. This is discussed in the following Part in paragraphs 61 to 67 below.

## **Part 4 - Will We Acquire Commercial Property?**

### **Introduction**

- 54 Where an authority is able to determine that it has legal powers to acquire commercial property and that it would be reasonable and prudent to exercise those powers, the final step in the process will be to confirm that authority wishes to proceed with an acquisition.
- 55 Authorities will usefully consider the contribution that an investment will make, in line with the principles stated in the Statutory Guidance. Consideration will not just refer to the financial aspects of yield and profit and the balance that property might bring to an authority's overall investment strategy, but also to the contribution that might be made to regeneration initiatives, business rates growth and amelioration of local market failure.
- 56 The consideration of contribution will have four main aspects:
- would investing in property be consistent with the authority's corporate strategy?
  - does the authority's investment strategy support an acquisition?
  - does the authority's property strategy accommodate the holding of property to make a commercial return?
  - does the authority have the competence in terms of expertise and experience to take effective decisions at appropriate levels to determine and then reflect the authority's risk appetite?

### **Corporate Strategy**

- 57 An authority seeking to invest in property will need to recognise that the activity has corporate implications. The clearest of these will be that the Government and the CIPFA Prudential Code have expressed views that it is not a legitimate activity where investment held purely for revenue raising purposes requires an authority to borrow.
- 58 However, there are also issues that might arise from the particular characteristics of property: that there is a finite supply and each property is fixed in its geographical location. This means that a participant in the market is likely to have an influence over the market and, where access is on favourable terms (such as access to cheap borrowing), potentially to distort the market.
- 59 Where property is being acquired outside an authority's area, then by definition the acquisition will be in the area of another local authority. Questions might be asked about the extent to which this would be helpful to the strategies of the other authority for its own area. However, if authorities only acquire properties in their own area, geographical inequity will arise in terms of the opportunities for returns to be made.
- 60 Authorities will need to take robust positions in relation to these issues, particularly as investment in property is normally regarded as a longer term strategy.

### **Investment Strategy**

- 61 Where the acquisition of commercial property does not have a continuing service objective, then the asset should be brought comprehensively within the scope of the authority's investment objectives contained in the capital strategy that authorities are required to compile under the Prudential Code. This may be problematic as property has

significantly different characteristics to the other investments normally made by an authority:

- investment in property is usually regarded as a long-term activity, whereas local government has traditionally sought to manage its surplus cash balances using relatively short-term instruments
- investment properties have a very different balance of security, liquidity and yield from most financial investments – the potential volatility of income will be particularly important for bodies required to balance the revenue budget on an annual basis
- acquisition will normally involve substantial transaction costs that will need to be taken into account when assessing yield
- holding the investment will require active management by the authority (or an agent) and involve ongoing expenditure to run the property and keep it in the required condition.

62 Authorities undertaking investments primarily for financial return should ensure that these are subject to enhanced decision making and scrutiny as a result of the additional risk being taken on and the potential impact on the sustainability of the authority. The capital strategy (or separate investment strategy) should set out clearly governance processes covering:

- consideration of different investment characteristics and risks, and the investment asset allocation appropriate to the authority, confirming when property investment might be appropriate and fixing its place in a balanced approach to the management of the authority's balance sheet
- how the authority's overall risk appetite will be determined including overall limits on investments and risk exposure, including by sub-category if appropriate
- the process by which the authority will bring forward opportunities, develop and approve outline business cases, consider full business cases and make final decisions allowing for sufficient scrutiny of decision making
- appropriate arrangements for professional due diligence, including arrangements for obtaining external advice.

63 The capital strategy approved by full council should set out the arrangements for the ongoing management and reporting of performance and risk in relation to investment portfolios. Where ongoing monitoring is delegated, triggers and arrangements for reporting by exception should be clearly established so that full council is aware at the earliest opportunity of any material increase in risk or threat to ongoing yield.

64 The capital strategy (or investment strategy) should set out clear methods and procedures for the ongoing monitoring and management of its investment portfolios. In setting performance measures it is important that they cover both the ongoing security of investments and ongoing yield, including any lifecycle costs required to maintain the income potential of any property based assets. Authorities should make extensive use of fair value information on investments to help in their management of ongoing risks, however, they should also be clear on the assumptions and limitations of such valuations. For example, the value realised from an investment may vary significantly from its fair value dependent upon the conditions under which it is disposed.

- 65 Market conditions can have a significant impact on both the value and yield of investments and can also have significant bearing on the liquidity of an asset, i.e. the ease with which an asset can be realised. Ongoing performance and management arrangements should include procedures to highlight key risks or changes in market conditions that may affect the security, liquidity and/or yield of the investment portfolio.
- 66 The authority should clearly determine its risk appetite in respect of non-treasury management investments, including financial assets and property investments. A key element of the risk strategy around any such investment strategy will be ensuring that the acceptable level of risk is determined with a clear focus on the impact of the downside risk on the overall sustainability of the authority. Key considerations may include:
- the level to which the balanced budget and council tax calculation is dependent upon income from investments and the certainty of the income moving forward
  - the amount of capital invested and the potential volatility of the fair value compared to the initial investment
  - how the investment is financed including the use of unearmarked reserves and borrowing
  - the liquidity of the investment compared to the longer term cash flow requirements of the authority.
- 67 Authorities should set out clear criteria for both investment decisions and the on-going risk management of their investment portfolios. In considering risk it is vital that not only the risks of individual investments are considered but also the cumulative impact of all the investments made by the authority and the interaction of individual risks.

### **Property Strategy**

- 68 Authorities will need to ensure that any investment properties are comprehensively accommodated in their property strategy.
- 69 Decision-making processes will need to address:
- how much understanding the authority requires of local and wider property markets
  - the need to appoint external advisers and agents
  - how investment opportunities are identified
  - how options are to be appraised
  - the due diligence that will take place into individual options
  - confirming the reasonableness of the acquisition price
  - implications for the authority's VAT partial exemption position.
- 70 Arrangements will need to be in place to manage the property following acquisition:
- general estate management arrangement
  - understanding management costs

- funding for running costs
- maintaining the sustainability of the investment.

71 New frameworks will also be required for assessing the performance of property as an investment:

- what will the valuation arrangements be?
- what other key performance indicators will be needed?
- how often should they be measured and who by (note that this issue is notwithstanding the financial reporting requirements)?
- what benchmarking can be done?
- how often will future property yields be reviewed and risk appetites recalibrated?

72 Contingency plans will also be needed to deal with potential under-performance:

- dealing with vacancies and defaults on rental payments
- strategies for falls in market value
- exit strategy.

### **Competence**

73 The complexities of investment in property mean that it is vitally important for the authority to be competent to take decisions to acquire, hold and dispose of land and buildings. This does not require all the expertise and experience to be in-house, but members and officers must have sufficient competence to understand and evaluate the advice they are given and make reasonable decisions in relation to it or to oversee the decisions taken by others.

74 There should be clear governance arrangements for the acquisition and management of commercial property, specifying decision-making powers and requirements for oversight. These should be an integral part of the Investment Strategy (see paragraph 62) and the Property Strategy (see paragraph 69).

75 The potential complexity of property deals and the extent to which they rely on longer-range projections of returns mean both that the investment risk is higher and that the skills needed to make judgements about this risk are more specialised. The authority must be able to take decisions about commercial property that fully reflect its formally approved Investment Strategy and the risk appetite that it has. The more complex the proposals, the greater the possibility that the authority will not have the competence to deal with them. No decisions should therefore be taken unless:

- advice has been obtained from advisers with appropriate expertise and experience (whether internal or external)
- advisers have been provided with all the information relevant to the provision of their advice, including the factual details of the proposals and the authority's risk appetite in relation to them

- where advice has been obtained from a number of different advisers, the advice has been effectively consolidated, so that it is clear where it is mutually supportive or where there are differences of opinion
- decision-makers have the appropriate skills to ensure that they are guided by the advice and not directed by it
- the decision is fully compliant with the Wednesbury principles for reasonableness (see paragraphs 17 and 18)
- the decision has been overseen effectively.

76 The Investments Statutory Guidance makes clear an expectation that an authority's investment strategy will detail:

- how assurance is secured that members and officers involved in decision making have appropriate capacity, skills and information to enable them to take informed decisions to acquire specific investments, to assess investments in the context of the authority's strategic objectives and risk profile and to understand the how decisions have changed the overall risk exposure of the authority
- the steps taken to ensure those negotiating commercial deals are aware of the core principles of the Prudential Framework and the regulatory regime
- the governance arrangements in place to ensure accountability, responsibility and authority for decision making, within the context of the authority's corporate values.

77 Before investing in property, authorities should have carried out an audit of the skills possessed by members and officers in relation to the skills required to take decisions about acquisition and ongoing management. Where there is a skills deficit, the authority should determine how it is going to make good the deficit or amend its plans.

78 Some proposals may have aspects that are commercially sensitive. However, where commercial sensitivity might restrict the oversight that could be given to a decision, the Investment Strategy should set out the conditions under which such proposals would be permitted to be considered and the safeguards that would need to be in place.

79 Decisions will also need to be subject to effective scrutiny. Where a private sector entity were proposing to borrow to acquire commercial property, the prospective lender would consider the proposal very carefully to determine how secure its advance would be and what interest rate to charge to reflect the risk being taken on. This scrutiny is not present in local government, where the PWLB will lend on request at a specified rate to an authority confirming that it is acting within its legal powers.

80 Authorities are recommended to seek to replicate a comparable level of scrutiny, which might involve commissioning external supporting opinions if there is not sufficient internal competence to make an effective assessment.

## **Annex A**

### **Powers to Acquire Investment Property**

A1 The fundamental question in establishing the legal power to acquire investment property (and to borrow to fund the acquisition) might appear trivial but has important consequences: is the authority primarily acquiring:

- a property, or
- an investment that happens to be a property.

Each of these purposes has its own range of supporting powers, with crucial differences as to the extent to which the property must contribute to the authority's service objectives and how the powers link with borrowing powers.

A2 The first step in any proposal to acquire investment property will be to confirm that the authority has the legal powers to:

- purchase or lease the relevant land and buildings, and
- operate them on a commercial basis.

A3 For any acquisition, legal advice should be obtained that covers both of these questions comprehensively.

#### **Property Acquisition**

A4 Authorities have general powers under section 120 of the Local Government Act 1972 to acquire land (inside or outside of their area) for the purposes of:

- any of their functions, or
- the benefit, improvement or development of their area.

A5 There are also specific powers, such as section 132 of the 1972 Act permitting the acquisition of halls and offices for public meetings and assemblies, and section 9 of the Housing Act 1985 allowing the acquisition of houses for the purpose of providing accommodation.

A6 Where specific powers are not relevant, the general power of competence provided by section 1 of the Localism Act 2011 gives local authorities power to do anything that individuals generally may do, subject to certain constraints. Among the more important of these constraints are that charges for services provided must be limited (taking one financial year with another) to recovery of the costs of providing the service (section 3) and that anything done for a commercial purpose must be done through a company (section 4).

A7 It is beyond the scope and competence of this guidance to provide advice on legal powers, but a significant conclusion from the range of powers available is that the greater challenge will not be identifying a power allowing the acquisition of rights to property but aligning the authority's reasons for purchasing or leasing the land and buildings with the statutory purposes that must be satisfied and the constraints that must be met in exercising the powers identified.

A8 If property acquisition powers are not exercisable in the particular circumstances, then reliance will presumably be sought on investment powers (see paragraphs A23 to A33).

### **Borrowing Powers**

A9 A particular issue for this guidance is the extent to which acquisitions can be supported by borrowing. Where an authority intends to fund an investment property transaction from loans, then legal advice will also be needed as to the extent to which this can be justified.

A10 This can be a complicated area. Authorities might need to borrow for many reasons, from addressing a temporary cash shortfall to financing a capital project that might have a life of 50 years or more. However, it is not always straightforward to map individual loans to particular purposes, such that a loan can be identified as directly supporting specific items of expenditure (and nor does the Prudential Code require it). Analysis might therefore need to consider as much how underlying requirements to borrow have come about (distinguishing in particular prudential borrowing and management of revenue activities) as why individual loans have been taken out.

A11 Powers to borrow are contained in section 1 of the Local Government Act 2003. A local authority is empowered to borrow money:

- for any purpose relevant to its functions under any enactment, or
- for the purposes of the prudent management of their financial affairs.

A12 These powers are constrained by section 3 of the Act, which requires local authorities to determine and keep under review how much money they can afford to borrow. In determining affordability of borrowing, local authorities are required by the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 (SI 2003 No 3146, as amended) to have regard to the Prudential Code.

A13 Consequently, where an authority identifies a power to acquire a property, then as the exercise of a function of the authority, borrowing would presumably be justified by the first part of the borrowing power to support that exercise. The second part would allow for funds to be raised where a cash deficit arises and where, for example, it would not be prudent to liquidate investments to cover the deficit.

A14 However, the two parts of the borrowing power might be difficult to separate in practice. It is not a customary practice for authorities to take out loans to support particular transactions. Most authorities will manage their cash flows on a consolidated basis across all their activities. Individual transactions such as property purchases will generate an underlying need to borrow but might not result in actual borrowing taking place, particularly because the authority might have surplus cash balances arising from its other business that can (at least temporarily) cover the cash out flow. These arrangements are referred to in the Prudential Code as "internal borrowing".

A15 This means that there can be significant but legitimate timing differences between an authority entering into a transaction that may need to be supported by borrowing and that borrowing actually taking place. Internal borrowing does not therefore remove the need to identify borrowing powers but relies on the existence of currently surplus cash balances to defer decisions actually to borrow.

A16 Clarity is provided by the need under the Prudential Code for authorities to keep a record of their Capital Financing Requirement (CFR). The CFR records the underlying need to borrow for capital purposes. It increases when capital expenditure is incurred and

reduces when resources are set aside to finance expenditure. The extent to which expenditure incurred exceeds the resources set aside measures the deficit that has to be funded from external or internal borrowing.

A17 A practical application of section 1 (Power to Borrow) of the 2003 Act might then entail deeming that the authority:

- commits to borrowing for a purpose relevant to its functions when a transaction is lawfully entered into that results in expenditure that increases the CFR
- incurs borrowing for the purposes of the prudent management of its financial affairs when loans are actually taken out as part of cash flow management arrangements.

A18 Use of the borrowing power would therefore be more difficult to justify where either there has been no increase in the underlying need to borrow or cash inflows do not currently need to be supplemented. There are two particular situations where these difficulties are most sharply focused:

- borrowing in advance of need
- on-lending.

A19 These two situations can be interlinked, but **borrowing in advance of need** usually refers to circumstances where an authority is forecasting a need for borrowing (usually by reference to its capital programme) and assesses that it would be favourable to take out loans before the relevant expenditure actually takes place. This would most commonly happen where interest rates for fixed rate borrowing are forecast to rise. In these circumstances, borrowing will lead to a temporary cash surplus that will require investment. An authority might forecast that any additional net interest payable in the period before the need for cash is actually projected to arise will be exceeded by the savings in interest payable after the loans would otherwise have been taken out.

A20 This is a generally accepted treasury management practice, which depends on accepting some risk of loss if forecasts are not proven correct. The practice becomes less prudent the further in advance of need that borrowing is taken out and as projections become more unreliable.

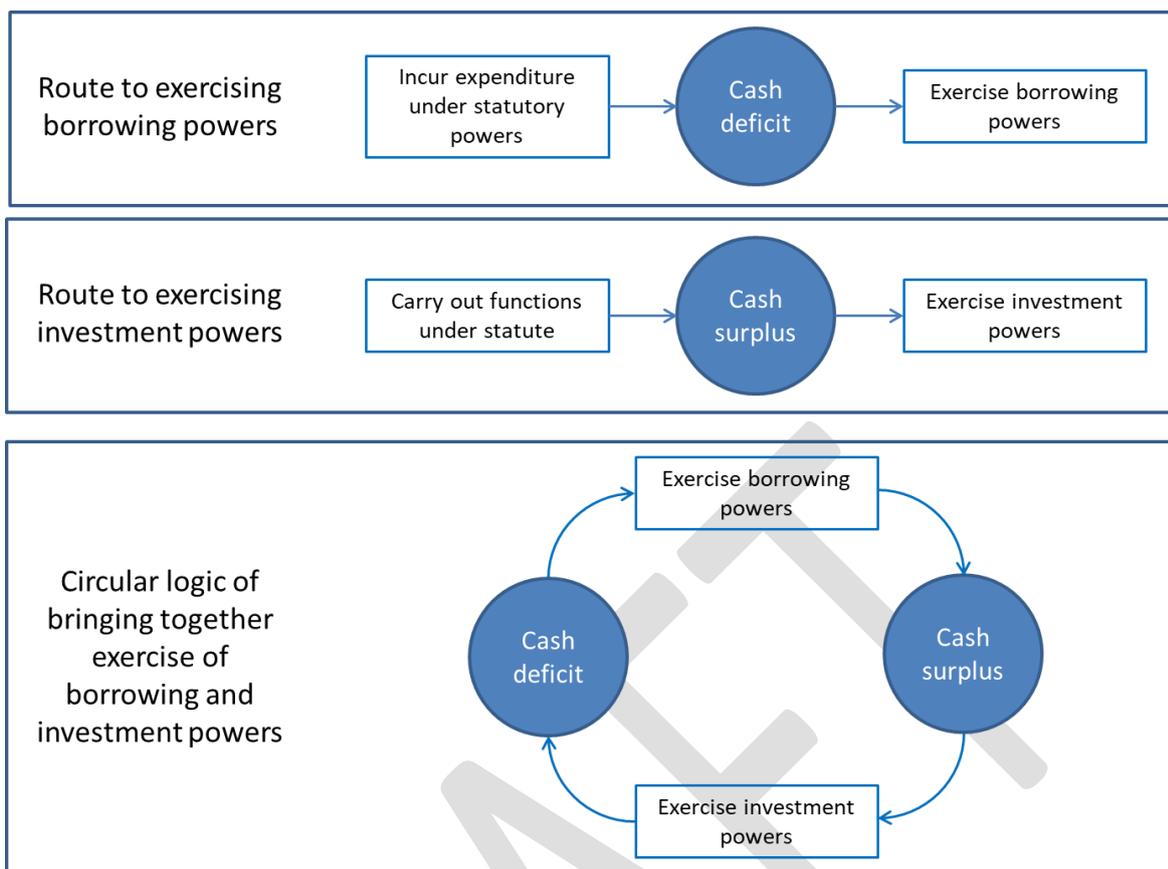
A21 This type of borrowing in advance of need differs from **on-lending**, where there is no projected need to borrow but an opportunity has been identified to make an investment return in excess of the authority's cost of borrowing. There is no purpose for the borrowing other than to make such a return.

A22 On-lending has traditionally been presumed to be unlawful and any authority proposing it will be careful to ensure that their legal advisers have considered the possible implications of historical precedents. Before PWLB lending rules were amended to put the onus for determining the legality of their loan applications onto authorities, they prohibited borrowing for the purposes of on-lending. Paragraph 45 of the Code reflects this history by stating:

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. Authorities should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds.

## Investment Powers

- A23 Arguments have been put that the circumstances changed since the Local Government Act 2003 introduced a primary power to invest, rather than investment being something that was done incidentally to an authority's other powers. Section 12 provides that an authority may invest in the same way that it may borrow:
- for any purpose relevant to its functions under any enactment, or
  - for the purposes of the prudent management of its financial affairs.
- A24 The 2003 Act does not define what would constitute investment. It is uncertain whether a commercial or an investment property would meet the statutory definition of an investment. The Government view, as expressed in the updated Statutory Guidance on Local Authority Investments, is that non-financial investments such as commercial property fall within the general definition of investments. However, the view has not been tested in the courts and so is not a definitive interpretation.
- A25** The issue will be important where the reasons for the acquisition of a property cannot reliably be aligned with one of the purposes for which the specific powers for property acquisition can be applied and section 12 of the 2003 Act is being relied upon. **Where a property is being acquired solely to generate an investment return, then the transaction is arguably constrained by section 12 and has therefore to be justified as a component of the prudent management of the authority's financial affairs. It should therefore exclude any substantial speculative elements.**
- A26 The first part of the section 12 (power to invest) set out in paragraph A23 suggests an intention that investment is not restricted solely to transactions involving the placement of surplus funds by an authority. Investment under the section 12 powers might cover functional transactions such as the acquisition of shares in companies and the making of loans to individuals and organisations for purposes that would relate to service objectives of the authority (eg, economic development), where making a financial return is not the primary concern. For such investments the fact that an arrangement might make a return would be a secondary issue and might even be an undesired outcome if, for instance, state aid rules require an authority to charge interest at a rate above its own cost of borrowing.
- A27 The second part of the section 12 power would more clearly relate to the stewardship of surplus cash held by an authority, where the prudent balancing of security, liquidity and yield is paramount. In order to apply this power, it would be a reasonable presumption that the surplus funds are already in the possession of the authority. Otherwise, there would be a problem of circular logic:
- if the authority does not have surplus cash, it will need to exercise its borrowing powers to secure it
  - but ... the exercise of borrowing powers is usually dependent on an authority incurring expenditure that will result in a cash deficit
  - and ... if the proposal is to borrow to invest, a cash deficit would only arise once the investment is made.
- A28 This problem with bringing together borrowing powers and investment powers is illustrated in the following diagram:



A29 This is the basis of the technical argument against on-lending for the purposes of making a return– that it is difficult to link the borrowing and investment powers as they are conditional on contrary positions – respectively having insufficient cash and having surplus cash.

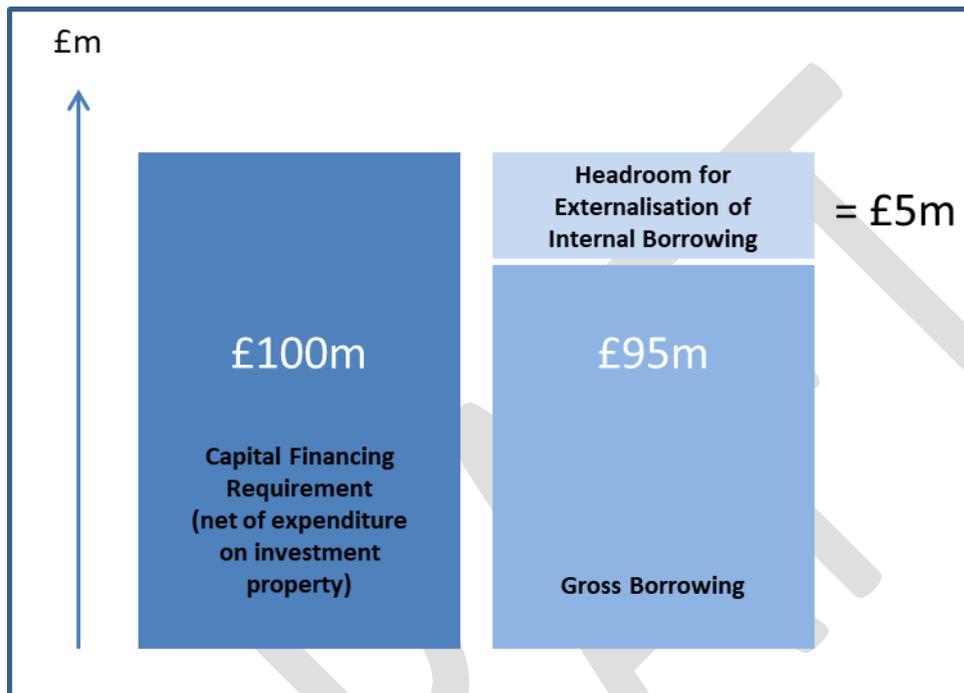
#### *The Impact of Internal Borrowing*

A30 The use of investment powers are further complicated by the internal borrowing issue. As interest rates for borrowing and investment move, the prudent management of an authority's financial affairs might properly involve the externalisation of internal borrowing – ie, taking out loans to cover historical expenditure that previously created a legitimate underlying need to borrow (but for which the existence of surplus cash balances allowed the deferral of actual borrowing). Externalisation could legitimately result in the taking out of loans, followed by the making of investments, in the interests of properly managing the authority's treasury position and rebalancing borrowing against investments in terms of the overall strategy for its cash flows.

A31 If externalisation of internal borrowing is being proposed, then it should be clear that the new external borrowing has a historical justification – ie, that it is in support of capital expenditure that has already been incurred and previously funded by the internal borrowing, not for the funding of future capital expenditure. The new borrowing should satisfy an existing underlying need to borrow for capital purposes, as measured by the Capital Financing Requirement.

A32 Particularly in relation to the acquisition of property solely as an investment, a rebuttable presumption could be made that borrowing in this instance should not lead to the authority's gross borrowing being in excess of its Capital Financing Requirement, excluding the expenditure on that property.

A33 The rebuttable presumption about headroom for the externalisation of internal borrowing is illustrated in the following diagram. Suppose that an authority currently has a CFR of £100m and loans outstanding of £95m. It proposes to acquire a property for £7m for no other purpose than as an investment. It could argue that £5m of new borrowing might be justified in support of the purchase, bringing gross borrowing up to the level of unfinanced historical capital expenditure. (This would require the investment need to be relatively long-term and able prudently to be satisfied by an illiquid commitment.) An argument would then be needed as to how the remaining £2m of the purchase price was not a form of on-lending:



## Annex B

### Detailed Specifications of the Statutory Guidance on Local Authority Investments

- B1 The detailed specifications of the 2018 edition of the MHCLG Statutory Guidance on Local Authority Investments and the associated observations in the Informal Commentary particularly relating to investment property are set out below.
- B2 Paragraph references are from the Statutory Guidance and the Informal Commentary. CIPFA commentary is marked by square brackets.

Statutory Guidance	MHCLG Informal Commentary
<i>Definitions</i>	
<p>"Investments" are defined in paragraph 4 to include "... all of the financial assets of a local authority as well as other non-financial assets that the organisation holds primarily or partially to generate a profit; for example, investment property ...".</p>	-
<i>Transparency and Democratic Accountability</i>	
<p>At least one Investment Strategy should be prepared for each financial year (paragraph 15), approved by full council before the start of the relevant year (paragraph 16).</p> <p>Material changes to the Strategy should be presented to full council before the changes are implemented (paragraph 17).</p> <p>The Strategy should be publicly available on the authority's website (paragraph 18).</p>	<p>Paragraph 14 of the Informal Commentary does allow limitation of disclosures about specific non-financial investments on grounds of commercial confidentiality, but expects this to apply in exceptional circumstances only. Appropriate professional advice should be obtained, considering the same criteria as would apply to excluding the public from a council meeting. The appropriateness of exclusion should be reassessed for each new strategy.</p>
<i>Contribution</i>	
<p>The contribution that Other Investments (those not held for treasury management purposes) make towards service delivery objectives and/or the authority's placemaking role should be disclosed, according to types of contribution defined by the authority (paragraph 22).</p>	<p>[The Guidance does not define clearly what "treasury management purposes" are. A practical definition might be that instruments come within this category if they have the security-liquidity-yield order of objectives.]</p> <p>Paragraph 19 of the Informal Commentary gives some examples of the contributions that can be made by Other Investments (confirming that it is not intended</p>

	<p>that "contribution" is restricted to the accounting sense):</p> <ul style="list-style-type: none"> <li>• yield/profit</li> <li>• regeneration</li> <li>• economic benefit/business rates growth</li> <li>• responding to local market failure</li> <li>• treasury management</li> </ul> <p>Investments contributing to regeneration or economic benefit should form part of a project in the Local Plan (paragraph 20).</p>
<p><i>Use of Indicators</i></p>	
<p>Paragraph 23 requires the Investment Strategy to include quantitative indicators that will allow members and the public to assess the authority's total risk exposure as a result of its Other Investment Decisions, covering how investments are funded and the rate of return received. If the investments are made with borrowed cash, the indicators used should reflect the additional debt servicing costs taken on.</p> <p>The indicators used are at the authority's discretion and will reflect local risk appetite and capital and investment strategies. Indicators used should be consistent from year to year (paragraph 24).</p> <p>Indicators should allow assessment of the risks and opportunities of Other Investments over their payback period and (where funded from borrowing) the repayment period of the loans taken out (paragraph 25).</p>	<p>Although the Guidance says that indicators are at the authority's discretion, paragraph 22 of the Informal Commentary contains a table of nine recommended indicators for Other Investments (descriptions provided in the IC):</p> <ul style="list-style-type: none"> <li>• Debt to net service expenditure (NSE) ratio <i>Gross debt as a percentage of net service expenditure, where net service expenditure is a proxy for the size and financial strength of the authority</i></li> <li>• Commercial income to NSE ratio <i>Dependence on non-fees and charges income to deliver core services - fees and charges should be netted off gross service expenditure to calculate NSE</i></li> <li>• Investment cover ratio <i>The total net income from property investments, compared to the interest expense</i></li> <li>• Loan to value ratio <i>The amount of debt compared to the total asset value</i></li> <li>• Target income returns <i>Net revenue income compared to equity (a</i></li> </ul>

*measure of achievement of the portfolio of properties)*

- Benchmarking of returns  
*As a measure against other investments and against other council's property portfolios*
- Gross and net income  
*The income received from the investment portfolio at a gross level and net level (less costs) over time*
- Operating costs  
*The trend in operating costs of the non-financial investment portfolio over time, as the portfolio of non-financial investments expands*
- Vacancy levels and tenant exposures  
*Monitoring vacancy levels (voids) to ensure the property portfolio is being managed (including marketing and tenant relations) so that the portfolio is as productive as possible*

It is recommended in paragraph 22 of the Informal Commentary that the indicators might be presented classified by type of contribution or risk appetite where the risk appetite or expectation of returns differs across the contribution types.

Paragraph 23 recommends targets or limits set by members should be included alongside the outturn. Significant changes in year on year performance should be explained in the Investment Strategy.

*[Some of these indicators presume a matching of borrowing to particular non-financial investments (eg, investment cover ratio), which might not be the case. An authority will need to make other arrangements for assessing the total cost of an investment property that can be modelled, perhaps based on deemed*

	<i>borrowing related to the Capital Financing Requirement.]</i>
<i>Security, Liquidity and Yield</i>	
Paragraph 28 requires for Other Investments that a balance of security, liquidity and yield is achieved based on the authority's risk appetite and the contributions made by the activity.	-
<i>Security</i>	
<p>The Investment Strategy should include the following disclosures:</p> <ul style="list-style-type: none"> <li>• where the fair value of the investment property provides sufficient security against loss, a statement that a fair value assessment has been made in the last 12 months and the underlying asset provides security for the capital investment (paragraph 38)</li> <li>• where fair value is insufficient to provide security against loss, detail of mitigating actions taken or proposed (paragraph 39)</li> </ul> <p>Where a loss is recognised in the fair value of a non-financial investment as part of the year end accounts and audit process, an updated Strategy should be presented to full council detailing the impact of the loss on security and any revenue consequences arising (paragraph 40).</p>	<p>Paragraph 28 of the Informal Commentary sets out that security in relation to investment properties should be assessed by comparing fair value to purchase price. It acknowledges that the capitalised cost of newly acquired property (including all directly attributable costs) might exceed its resale value around the time of acquisition, in which case the Strategy should disclose how long it is expected to take for an increase in value to cover cost and the assumptions underpinning the expectation.</p> <p>[Although acquisition costs are considered, the Informal Commentary does not mention two other important variables:</p> <ul style="list-style-type: none"> <li>• subsequent expenditure on refurbishment and replacement of components which has been capitalised and</li> <li>• the extent to which MRP has been set-aside for the cost of the property.</li> </ul> <p>Both of these could be very relevant to determining the extent to which any adverse movement in the value of a property would have a resourcing effect on an authority – subsequent expenditure increasing the need for cover; MRP reducing it. See paragraphs 30 to 37 above.]</p> <p>Paragraph 29 reminds authorities that non-financial investments are illiquid and that technological change might mean that investments will not</p>

	<p>deliver value over their whole lifetime. Authorities should have plans to realise tied-up capital if required. [The idea of specific debt taken out to acquire assets is raised again here, such that, if additional debt servicing costs were to arise on refinancing, the authority would be able to assess the trade-off between higher costs or capital loss from liquidation of the asset.]</p>
<p>Paragraph 41 recommends that the Investment Strategy should set out the approach to assessing risk of loss before entering into and whilst holding Other Investments, in particular:</p> <ul style="list-style-type: none"> <li>• how the market the authority is competing in has been assessed, the nature and level of competition, how the market/customer needs will evolve over time, barriers to entry and exit and any ongoing investment requirements</li> <li>• whether and, if so how, a local authority uses external advisors (treasury advisers, property professionals, etc)</li> <li>• how the quality of external advice is monitored and maintained</li> <li>• to what extent, if at all, risk assessment is based on credit agency ratings</li> <li>• where credit ratings are used, how frequently they are monitored and the procedures for action if they change</li> <li>• what other sources of information are used to assess and monitor risk.</li> </ul>	<p>-</p>
<p><i>Liquidity</i></p>	
<p>For non-financial investments, the Strategy should disclose:</p> <ul style="list-style-type: none"> <li>• the procedures for ensuring that the funds can be accessed when they are needed</li> <li>• the authority's view of the liquidity of the investments that it holds, recognising that assets can take a considerable period to sell in certain market conditions (assessed by class of asset or at a portfolio level if appropriate) (paragraph 43).</li> </ul>	<p>-</p>

<p><i>Proportionality</i></p>	
<p>If plans feature dependence on profit-generating investment activity to achieved a balanced budget, paragraph 44 requires the Strategy to:</p> <ul style="list-style-type: none"> <li>• detail the extent to which funding of service delivery objectives is dependent on achieving the expected net profit</li> <li>• set out contingency plans should the authority fail to achieve the expected net profit</li> </ul> <p>Paragraph 45 requires that the assessment should as a minimum cover the life-cycle of the Medium Term Financial Plan, but recommends assessment of longer term risks and opportunities.</p>	<p>Paragraph 30 of the Informal Commentary cautions that attention to the long term sustainability risk implicit in becoming over-dependent on commercial income or in taking out too much debt relative to net service expenditure. Although borrowings are by force of statute secured on the revenues of an authority, those revenues may be insufficient to cover material losses.</p> <p>Paragraph 31 expresses a Government view that that authorities should not take on debt to acquire investment properties. If an authority sets limits for commercial income as a percentage of net service expenditure and finds that it exceeds these because of property acquired before the introduction of the revised Guidance, paragraph 33 excuses authorities from disposing of any of the investments, but no further investments should be entered into, apart from short-term Treasury Management Investments.</p>
<p><i>Borrowing in Advance of Need</i></p>	
<p>Paragraph 46 declares a prohibition on borrowing more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.</p> <p>If this prohibition is disregarded, and the authority borrows or has borrowed purely to profit from the investment of the extra sums borrowed, the Investment Strategy should explain:</p> <ul style="list-style-type: none"> <li>• why the authority has decided not to have regard to this Guidance or to the Prudential Code</li> <li>• the authority’s policies in investing the money borrowed, including management of the risks, eg, not achieving the desired profit or borrowing costs increasing</li> </ul>	<p>The wording of the prohibition is similar to a provision in the Prudential Code. The crucial difference in the Statutory Guidance, as confirmed by paragraph 34 of the Informal Commentary, is that the Government believes that the prohibition extends specifically to investment properties.</p> <p>Paragraph 35 warns against manoeuvring capital receipts previously committed to investing in services to avoid borrowing for the acquisition of investment property.</p>
<p><i>Capacity, Skills and Culture</i></p>	

Paragraph 48 requires that the Investment Strategy should disclose the steps taken to ensure that members and officers involved in investments decision-making have appropriate capacity, skills and information to:

- enable them to take informed decisions as to whether to enter into a specific investment
- assess individual assessments in the context of the strategic objectives and risk profile of the authority
- enable them to understand how the quantum of these decisions have changed the overall risk exposure

Paragraph 49 requires the Strategy to disclose the steps taken to ensure that those negotiating commercial deals are aware of the core principles of the Prudential Framework and of the regulatory regime within which the authority operates.

The Strategy should comment as appropriate on the corporate governance arrangements that have been put in place to ensure accountability, responsibility and authority for decision making on investment activities within the context of the authority's corporate values.

Paragraph 39 of the Informal Commentary confirms that it is not expected that members receive formal training – an internal presentation setting out in layperson's terms the risks and opportunities of strategies and particular proposals may be sufficient.

Where the authority has brought in outside expertise to identify and negotiate investment opportunities, paragraph 40 advises that those negotiating deals understand that they are not operating in a purely commercial environment but one where the prime purpose is to deliver statutory services to local residents. The Strategy should comment on how negotiators have been made aware of this.