CIPFA The Chartered Institute of Public Finance & Accountancy

# Local Authority Commercial Investment

## Public Accounts Committee

## Submission by:

## The Chartered Institute of Public Finance and Accountancy

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the people in public finance

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

Further information about CIPFA can be obtained at [www.cipfa.org](http://www.cipfa.org)

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## 1. Executive Summary

1.1 In 2004 local government transitioned from a centralised capital control environment to a principles based framework which allowed authorities the local flexibility to make acquisitions to improve economic growth and encourage regeneration within their area.

1.2 Since then, capital programmes have been supported by a framework which ensures affordability, prudence and sustainability. A framework which continues to operate successfully. CIPFA concludes that:

- from its inception, the successful operation of the prudential framework has enabled a centralised capital control system to be replaced by a more modern system based on local responsibility
- essentially, the current system is a good one. It enables a professionally supported principles based system to operate comfortably with a clear legislative framework. CIPFA considers that the principles based system should be preserved and, if necessary, strengthened, and that
- the principles based system allows creativity and innovation within the framework but also allows it to be flexible with direct intervention which does not require legislation

1.3 CIPFA does however recognise that increased use of borrowing for commercial activity does not represent proper use of public funds. Three recent and significant interventions are anticipated to result in the required regulatory effect:

- firstly by modification to the Prudential Code in 2017 to require the development and publication of an annual capital strategy and the statutory guidance published by MHCLG
- secondly, CIPFA's publication of new guidance in autumn 2019 focused upon commercial property investment, and
- thirdly, and somewhat significantly, The Public Works Loans Board announcement in April 2020 that it would consult on ceasing to provide PWLB loans for commercial investments.

1.4 CIPFA considers that the impact of these measures have yet to be reflected in the wider system and that the combined impact in due course, is likely to be the suppression of borrowing for commercial transactions

1.5 CIPFA's submission is designed to provide focused factual information to the Committee to enable its scrutiny of this important area. Consequently, CIPFA provides commentary on the following areas in this submission:

- the importance of a principles based prudential framework

- the role of borrowing in a commercial portfolio
- the Commercial skills required, and
- financial sustainability.

1.6 CIPFA will examine the conclusions of the Public Accounts Committee carefully. We further commit to determining what modifications to the Code and or guidance are required as a result of the Committees deliberations and to act on them. We will also work with MHCLG to determine what scope there is within legislation to modify the current option whereby a local authority can choose not to have regard to the Code.

1.7 Finally, while there has been an understandable focus upon the consequences of borrowing for commercial purposes in recent times, CIPFA's message to the Committee is that it is crucial that the strengths of a principles-based system should be recognised and retained.

## 2. Introduction

2.1 Over the last five years there has been a growing trend for authorities to acquire land and buildings with the express intention of supplementing their revenue budgets with rental income. This type of activity is not recent and local authorities have operated safely and effectively in this space for many years.

2.2 The growing concern has been centred the around the volume of transactions that have taken place and the way that these activities have been funded. PWLB borrowing has increased and the nature and type of acquisition for a small number of local authorities has changed to include more commercial activity[1].

2.3 Guidance has always been given that borrowing purely to make an investment return is not permissible. The Ministry of Housing, Communities and Local Government's (MHCLG) Statutory Guidance on Local Government Investments[2] and CIPFA's Prudential and Treasury Management codes[3] have all been updated recently to address the implications of investment in property recognising that a small number of councils were failing to adhere to the framework.

2.4 CIPFA recognises that the Public Accounts Committee is focused on the Departments oversight of this area including the extent to which it formally monitors commercial activity and long-term exposure to risk. However CIPFA would like to ensure that the Committee has been made aware of the following areas which CIPFA believes to be central to this discussion.

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1 NAO Local Authority in Investment Property Report February 2020

2 MHCLG Statutory Guidance on Local Authority Investments February 2018

3 CIPFA Prudential Code for Capital Finance in Local Authorities December 2017.

## 3. The Importance of a Principles Based Prudential Framework

3.1 The Local Government Act 2003[4] sets the legal framework within which each local authority is able to undertake capital expenditure and by which central government is able to regulate that activity.

3.2 Importantly it establishes statutory powers to borrow, but at the same time establishes a statutory duty for local authorities to set an affordable borrowing limit. Affordability therefore is a 'principle' but is also a statutory duty.

3.3 The legislative framework is then supported by statutory guidance issued under section 15 of the Act and the two professional codes produced by CIPFA. Both codes are afforded their statutory support as specified under the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003, as amended. Notably a local authority can choose not to have regard to the Code. There is therefore scope to immediately strengthening the framework by precluding any option of disregard.

3.4 The CIPFA Prudential Code for Capital Finance in Local Authorities is a professional Code which allows authorities to demonstrate that they have met the statutory provisions of the Local Government Act 2003.

3.5 The objectives of the Code are simple but very effective: that capital expenditure plans are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice.

3.6 Consequently, CIPFA considers that the system is a good one. It enables a professionally supported principles based system to operate comfortably within a clear legislative framework while retaining flexibility for individual decision making under those core principles.

3.7 One of the clear benefits is that any required intervention is by the release of professional guidance. This is generally preferable to intervention by government (including the devolved administrations) which would necessarily require a longer timeframe.

3.8 Since its inception the framework has operated successfully and has enabled a centralised capital control system to be replaced by local responsibility. While there has been an understandable focus on the consequences of borrowing for commercial purposes, it is crucial that the strengths of a principles based system where decisions are made locally, should be recognised and retained.

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[4] The Local Government Act 2003 & Capital Finance and Accountancy Regulations 2003

## 4. The Role of Borrowing in a Commercial Portfolio

4.1 Over the last five years there has been a growing trend for authorities to borrow to acquire land and buildings with the express intention of supplementing their revenue budgets with rental income. During that period there has been intervention by government and by CIPFA.

4.2 The Prudential Code reflects the statutory position that local authorities must not borrow in advance of need purely in order to profit from sums borrowed. CIPFA would note that this principle expressed as follows in the Prudential Code is well understood for financial investments

*"must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed"*[5]

4.3 The increased scale of investment in property was recognised in 2017 by revisions to the CIPFA Prudential Code and to 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[6].

4.4 In February 2018, the government updated its statutory guidance for both local authority investments and minimum revenue provision to address property investments, particularly to provide a view that borrowing to acquire investment assets, including commercial property, is unlikely to be prudent[7].

4.5 CIPFA's role in the wider framework is to develop and keep under review the Code and associated guidance. This is undertaken within CIPFA governance by CIPFA's Capital and Treasury Management Panel. The panel includes expert practitioners, representatives from the audit community and representatives from government. Any guidance issued is intended to expand upon the requirements of the Code to enable adherence to the framework.

4.6 Both the CIPFA Prudential and Treasury Management Codes are CIPFA statements of professional practice (alongside other Codes such as the Accounting Code of Practice and the new Financial Management Code). As such, CIPFA members are required to follow these Codes as a part of their professional responsibilities.

4.7 While the production of the Prudential and Treasury Management Codes are as a point of principle prepared independently of government, as professional Codes, CIPFA consults with government both formally and

[5] CIPFA Prudential Code for Capital Finance, page 3, paragraph E16
[6] CIPFA Treasury Management in the Public Services, Section 8
[7] MHCLG Statutory Guidance on Local Authority Investments February 2018

informally throughout their development. This means that the framework benefits from both professional, regulatory and legislative oversight.

4.8 Recently there have been three significant interventions. Firstly by modification to the Prudential Code in 2017 and statutory guidance from MHCLG[8]. Secondly publication of new guidance by CIPFA in autumn 2019[9] which was focused upon commercial property investment. Thirdly and somewhat significantly, the Public Works Loans Board announced in March 2020 that it would consult on ceasing to provide PWLB loans for commercial investments[10].

4.9 CIPFA considers that the impact of these measures have yet to be reflected in the wider system but that the combined impact is likely to be the suppression of borrowing for commercial transactions

## 5. The Commercial Skills Required

5.1 The NAO reported concerns[11] on local authority governance including some concern around the skills and capacity to make initial investment decisions and for longer term investment management. CIPFA's guidance to local authorities in 2019 had also recognised this key area and considered the skills required.

5.2 The core issue was that irrespective of how they are funded, the commercial activities of local authorities has resulted in the sector holding a portfolio of commercial properties. The development of a direct commercial property portfolio has consequently placed local authorities in the position of being commercial landlords with a requirement to manage commercial properties, a role typically undertaken by private sector organisations.

5.3 Local authorities have historically managed social housing but a commercial portfolio in the private sector places different demands on the local authority. 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.

5.4 This does not require all of 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.

5.5 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.

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[8] MHCLG statutory Guidance, February 2018

[9] CIPFA Prudential Property Investment, November 2019

[10] HM Treasury, PWLB Future Lending Terms Consultation, March 2020

[11] NAO February 2020

5.6 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.

5.7 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. CIPFA has therefore provided the following guidance[12] that no decisions should 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; and
- the decision has been overseen effectively

5.8 In practical terms, 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.

5.9 Where there is a skills deficit, the authority should determine how it is going to make good the deficit or amend its plans.

5.10 Decisions will also need to be subject to effective scrutiny. Where a private sector entity was 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 Public Works Loan Board (PWLB) at present will lend on request at a specified rate to an authority confirming that it is acting within its legal powers.

5.11 It should be noted however that the PWLB is currently consulting on modifications to its lending arrangements. The central proposals is that borrowing for direct investment will be specifically precluded from access to PWLB funds[13]. CIPFA considers that this intervention will have a significant

[12] CIPFA Prudential Property Investment, November 2020

[13] HM Treasury, PWLB Future Lending Terms Consultation, March 2020

effect although will not minimise the need for internal competence in scrutiny.

## 6. Financial Sustainability

6.1 The Committee's focus on financial sustainability is welcomed. The prime policy objective of a local authority's investment activities is the security of public funds. In effect a local authority should avoid exposing public funds to unnecessary or unquantified risk.

6.2 The NAO report describes the view of local authorities that investment income is necessary to supplement revenue budgets and, by extension to ensure financial sustainability.

6.3 Where a local authority's plan features dependence on profit-generating investment activity to achieve a balanced budget, then there should be a clear strategy to:

- detail the extent to which funding of service delivery objectives is dependent on achieving the expected net profit; and
- set out contingency plans should the authority fail to achieve the expected net profit.

6.4 Any assessment should as a minimum, cover the life cycle of the medium-term financial plan, but recommends assessment of longer-term risks and opportunities.

6.5 Informal Commentary by MHCLG[14] expresses caution around 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.

6.6 Crucially, there is a stated government view that authorities should not take on debt to acquire investment properties which aligns to the Prudential Code. 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 of the informal commentary that supports the guidance excuses authorities from disposing of any of the investments, but no further investments should be entered into, apart from short-term treasury management investments.

6.7 Authorities undertaking investments primarily for a commercial 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 clearly set out governance processes covering:

[14] MHCLG February 2018

- 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, included by sub-category if appropriate; and
- 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.

6.8 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 will 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; and
- the liquidity of the investment compared to the longer-term cash flow requirements of the authority.

**Appendix**

## Property Investment - CIPFA's Guidance to Local Authorities [Extract]

CIPFA's guidance explains the provisions in the updated Prudential Code and Framework that relate to the acquisition of properties intended to make investment returns.

It also sets out to assist in identifying the implications in the light of growing activity and the changes to statutory guidance.

To acquire commercial property within the context of the prudential framework CIPFA considers therefore that local authorities are required to address three questions:

- Can we acquire a commercial property?
- Should we acquire a commercial property?
- Will we acquire a commercial property?

### Can we acquire a commercial property?

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. 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. This position reflects the circumstances that local authorities must not borrow 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.

### Should we acquire a commercial property?

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's Statutory Guidance on Local Government 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's 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.

### Will we acquire a commercial property?

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.

**Note: above text extracted from CIPFA's Prudential Property Guidance November 2019**