WORCESTER CITY COUNCIL

INVESTMENT STRATEGY

2019/20 -2021/22

DRAFT

February 2019

Introduction

This Investment Strategy fulfils the requirement, under statutory guidance published by the Ministry for Communities and Local Government (MHCLG) in January 2018, to provide an overview of proposed service and commercial investments planned to be undertaken from 2019/20.

The Authority invests its money for three broad purposes:

- because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments)**,
- to support local public services by lending to or buying shares in other organisations **(service investments)**, and
- to earn investment income (known as **commercial investments** where this is the main purpose).

This investment strategy focuses on the second and third of these categories.

Treasury Management Investments

The Authority typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure and collects local taxes on behalf of other local authorities and central government. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from the Chartered Institute of Public Finance and Accountancy. The balance of treasury management investments is expected to fluctuate between 11m and £9m during the 2019/20 financial year.

The contribution that these investments make to the objectives of the Authority is to support effective treasury management activities. Full details of the Authority's policies and its plan for 2019/20 for treasury management investments are covered in a separate document, published as Appendix 4 to the Budget Report 2019/20.

Service Investments: Loans

The Council has the opportunity to lend money to suppliers, local businesses, local charities, housing associations, local residents, its employees and its subsidiaries (should it have any) to support local public services and stimulate local economic growth. At present the Council has no loans of this sort in place but is in discussion with third parties about providing such facilities in order to unlock developments which might not otherwise be possible.

In each case the intention is to further the aims of the City Plan and use the Council's existing reserves, or its capacity to borrow, to support these objectives. In doing so the Council must have regard to regulations, CIPFA guidance, and legislation relating to State Aid. Under these rules the Council cannot use public funds above a certain financial limits to provide an advantage to a commercial entity which would otherwise need to obtain financing at market rates. However there are exemptions to these rules covering

- Regional aid
- aid to SMEs in the form of investment aid, operating aid and SMEs' access to
- finance
- aid for environmental protection
- aid for research & development & innovation
- training aid
- recruitment and employment aid for disadvantaged workers and workers with
- disabilities
- aid to make good the damage caused by certain natural disasters
- social aid for transport for residents for remote regions
- aid for broadband infrastructures
- aid for culture and heritage conservation
- aid for sport and multifunctional recreational infrastructures
- aid for local infrastructure.

In any event it is essential to meet the terms and maximum aid amounts set out in the regulations.

The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this risk, and ensure that total exposure to service loans remains proportionate to the size of the Authority, upper limits on the outstanding loans to each category of borrower need to be set. Table 1 shows upper limits on lending by type of provide. These limits are based on proposals under discussion as at the date of this report.

Table 1: Loans for service purposes

Category of borrower	**2019/20**
	Proposed Limit £000
Local charities	4,000
Housing associations	3,000
TOTAL	7,000

Accounting standards require the Authority to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Authority's statement of accounts from 2019/20 onwards will be shown net of this loss allowance in the event that loans are made. However, the Authority makes every reasonable effort to collect the full sum leant and has appropriate credit control arrangements in place to recover overdue repayments.

The Authority will assess the risk of loss before entering into, and whilst holding, service loans by detailed scrutiny of proposed cashflows of the loanee and by annual review of the loan arrangement. Individual reports of each proposal will set out overviews of such cashflows and identify potential risks in advance of any decision to proceed. All such decisions will be subject to agreement by the Policy & Resources Committee.

The following principles will form part of this strategy:

- Independent external advice will be sought and considered prior to provision of such loans
- Credit ratings will be used to asses risk where these are available and company financial assessments where appropriate
- Loans will be secured against appropriate assets and/or subject to guarantees in the event of default.

The statutory guidance requires that the Council Set limits on shares and other non-specified investments. The Council currently does not hold shares in third parties or subsidiaries and has no plans to make such investments, other than investment in the CCLA Property Fund. Investment in the fund as at 31 March 2019 is approved in accordance with the report agreed by the Income Generation Sub-committee at its meeting of 16 January 2018 with a maximum proposed investment of £5m. The current level of investment is £3m which his expected to generate a return of £120,000 (4%) in 2018/19.

Shares are the only investment type that the Authority has identified that meets the definition of a non-specified investment in the government guidance. The limits above on share investments are therefore also the Authority's upper limits on non-specified investments. The Authority has not adopted any procedures for determining further categories of non-specified investment since none are likely to meet the definition

Commercial Investments: Property

Statutory accounting definitions hold property to be an investment when it is held primarily for commercial purposes: i.e. to generate a profit. MHCLG guidance defines property to be an investment if it is held primarily *or partially* to generate a profit.

The Council currently invests in local commercial and residential property for a variety of reasons, according to historical decisions. This includes the intention of making a profit that will be spent on local public services. The income derived from these sources is £393k as set out in Table 2.

Table 2: Income from existing 'commercial' holdings

Type of holding	**Annual income (£)**
Land	184,985
Property	36,865
Leisure sites	104,389
Other	66,514
Total	**392,753**

Excluding those sites (primarily leisure ones) which are purely held for service delivery purposes, the book value of existing investments defined as 'commercial investments' for accounting purposes as at 31 March 2018 is £5.294m, providing a gross income of £212,000 p.a.

In accordance with government guidance, the Authority considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

Should the 2018/19 year end accounts preparation and audit process value these properties below their purchase cost, then an updated investment strategy will be presented to Full Council detailing the impact of the loss on the security of investments and revenue consequences arising therefrom. This process will form part of the development of an Asset Management Strategy which will be completed once the transfer of all relevant data from PPL is completed in April 2019.

The Authority assesses the risk of loss before entering into and whilst holding property investments by reviewing the expected cash flows for each scheme under three scenarios: best, standard and worst case. The Commercial Strategy requires that only projects which meet the following criteria will be actively considered:

- The projected cash flows result in a positive outcome over the lifetime of the project under all recognised scenarios
- There is a positive return to the MTFP over the lifetime of the project
- There is a positive return, including use of contingencies, over the first five years.

Non-financial risks will be assessed in accordance with the Council's risk assessment procedures and a risk register compiled for each viable project that meets the qualification criteria established above.

Following the above assessment six weighted criteria will be used, as outlined in the Commercial Strategy. Projects falling outside these criteria will not be considered.

Two overarching criteria are also to be applied:

- Does the proposal include opportunities for local regeneration or enhanced services for target areas?
- Does the project generate secondary income for Worcester, such as business rates?

Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. As the Council proposes to undertake such investment for regeneration as well as commercial purposes the option to sell the asset to recover costs must be balanced against the need to retain the asset to secure the development potential. The resale value is considered as part of the risk assessment for each proposal.

Should the costs of investment properties outweigh the income required to meet the financing costs of the investment, the Council will follow the strategic approach set out in its Commercial and Asset Management Framework approved by the Policy and Resources Committee on 29 October 2018. This requires that all assets, including commercial assets, are subject to a cyclical ‘fit for purpose’ review that ‘invest or dispose’ decisions are taken in the light of that review.

Loan Commitments and Financial Guarantees

Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Authority and are included here for completeness.

The Authority has no existing contractual commitments to make loans to any organisations and does not propose to make such commitments at this stage. The Authority has made guaranteed arrangements under the Local Authority Mortgage Scheme (LAMS) but this scheme has now closed and all potential liabilities have ceased.

Proportionality

The MTFP approved by Council at its meeting in February 2018 included proposals for generating additional income from new sources amounting to £200,000 per annum from 2019/20. The Development Fund report set a limit of £20m on the Fund as this is sufficient, at 1% return including borrowing costs, to generate the required £200,000. If this objective is achieved the Council will be dependent on income generating investment activity to achieve a balanced revenue budget.

Table 3 shows the extent to which the expenditure planned to meet the service delivery objectives and/or place making role of the Council is dependent on achieving the expected net profit from current ‘commercial property’ investments over the lifecycle of the Medium Term Financial Plan. It can be seen from the table that there is currently only a marginal reliance on income from these sources.

Table 3: Proportionality of existing 'commercial Investments'

	2017/18 Actual £'000	2018/19 Forecast £'000	2019/20 Budget £'000	2020/21 Budget £'000	2021/22 Budget £'000
Gross service expenditure	21,712	20,618	21,264	21,339	21,708
Investment income	212	212	212	212	212
Proportion	1.0%	1.0%	1.0%	1.0%	1.0%

Implementing the Development Fund report proposals in full would increase the extent to which the Council would be reliant on investment income to meet the costs of services, as shown in Table 4. This includes income from the CCLA Pooled Property Fund.

Table 4: Proportionality of proposed 'commercial Investments'

	2017/18 Actual £'000	2018/19 Forecast £'000	2019/20 Budget £'000	2020/21 Budget £'000	2023/23 Budget £'000
Gross service expenditure	21,712	20,618	21,264	21,339	21,708
Investment income	212	332	432	532	532
Proportion	1.0%	1.6%	2.0%	2.5%	2.4%

It can be seen from Table 4 that reliance on income from commercial property investment remains marginal and proportionate to Council's finances as at the date of this report. The overall limit on risk arises from the upper limit on the Development Fund. Any change to this limit would affect the above indicator which, accordingly, will be reported should any change be proposed.

Borrowing in Advance of Need

MHCLG guidance is that local 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 Development Fund report makes clear that the Council will not borrow purely for the purposes of investing to generate a profit but will seek to secure a reasonable return on its strategic investments. Paragraph 3.5 of the Development Fund report is as follows:

To progress its intentions under the October 2016 Cabinet report, therefore, the Council will need to ensure that either it invests existing resources in commercial activity (i.e. does not enter into borrowing for the purpose) and/or ensures that *the investment is not solely for the purposes of generating profit. Currently, local authorities can purchase land, either within or outside the local authority area, 'for the purposes of....the benefit, improvement or development of their area' under Section 120 of the 1972 Local Government Act. The purchase and development of both land and building assets 'to encourage economic growth and a healthy and more active population' can be done under the general power of competence as these form part of the stated intentions in the approved City Plan.*

The Council's policies in investing the money borrowed, including management of the risks, for example, of not achieving the desired profit or borrowing costs increasing are to:

- Maintain an overall limit on the Development Fund
- Budget on the basis of best, standard and worst case scenarios to ensure that income continues to exceed costs under all scenarios
- Undertake 'fit for purpose' reviews in line with the Capital and Asset Management Framework annually for investment properties
- Maintain adequate investment and sinking funds for each asset to mitigate additional losses
- Set an appropriate 'proportionality cap' to moderate the extent to which the Council becomes reliant on such income. It is proposed that this cap be set at 5% from 2019/20 in respect of the 'proportion' row identified in Table 4

Capacity, Skills and Culture

The decision to acquire land or property must be on the basis that it is a sustainable investment and therefore will be capable of generating an annual revenue return or a realisable capital receipt at a later date. The Council could take the decision to invest in property for the furtherance of the City Plan aims without expectation of a financial return but would at least need to realise the value of any purchase in its balance sheet. As this will require a clear decision-making rationale, the Development Fund report set out a two stage decision-making process to ensure that those responsible for making the decision had sufficient sight of the proposal:

- Stage 1: assess the potential of the proposed site both in terms of its contribution to the Council's aims and in terms of its financial return and make a conditional offer

- Stage 2: Undertake due diligence work and formally approve/reject purchase.

The Income Generation Sub-committee has responsibility for ensuring that these processes are followed and has the opportunity to scrutinise any proposal in detail. The Policy & Resources Committee will make the final decision on the basis of recommendations made by the Sub-committee. All proposals are subject to:

- Detailed review of proposed cashflows under best, standard and worst case scenarios
- Consideration of independent advice from third party experts on the viability of the scheme and the assessment of value
- Formal asset surveys and legal assessment to identify any risks inherent in the scheme

The indicators set out in this Strategy and the requirements of reporting in each individual proposal will ensure that elected members and statutory officers involved in the investments decision-making process have appropriate capacity 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 local authority
- enable them to understand how the quantum of these decisions have changed the overall risk exposure of the local authority.

All decision will be taken in line with the Development Fund report, the Commercial and Income Generation Strategies and the Capital and Asset Management Framework to ensure that due regard is made to statutory guidance as summarised in these documents, risk management, the possibility of financial loss and accountability for decision–making in respect of commercial investments.

Investment Indicators

It is proposed to set the following quantitative indicators to allow elected members and the public to assess the Council's total risk exposure as a result of its investment decisions. Annual reports are proposed but more frequent reporting will be considered following regular risk assessment of the investment portfolio.

Total risk exposure: The first indicator will show the Council's total exposure to potential investment losses. This will include amounts the Council is contractually committed to lend but have yet to be drawn down and any guarantees the Council has issued over third party loans.

How investments are funded: Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with.

Since April 2007 the Council has not funded any investments through borrowing. Prior to that date, the cumulative figure for the underlying need to borrow does not provide granular analysis to identify individual assets. Should investments take place under the Development Fund this indicator will be populated. If not funded through borrowing, the remainder of the Council's investments are funded by usable reserves.

Rate of return received: This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred. All individual proposals to be considered under the Development Fund will include this indicator as part of decision making, in accordance with the Commercial Strategy and Development Fund report.