apse membership resources

Briefing 17- 47 **December 2017**

Consultation on changes to the Prudential Framework

This briefing considers the Government consultation on changes to the Prudential Framework. It considers:-

Proposed changes to the prudential framework of capital finance and subsequent draft codes on Local Authorities Investment and Minimum Revenue Provision Guidance

It will be of particular interest to those with responsibility for commercialisation programmes, assets and investment strategies, and regeneration.

1. Introduction

Local authority investment decisions have been making headlines in recent months, with some elements of the national press calling into question the role of local authorities investing in property and assets as a means to generate income. However as funding has decreased councils have increasingly relied upon new sources of income to plug the funding gaps. Councils investing in property, and other assets, is nothing new; many local authorities have historical held major assets including retail sites, farms and residential property. In recent years however the emphasis on using these assets to generate a commercial yield has become much greater and this has involved out of area investment. Whilst the exact figures for this type of investment is not fully quantifiable a recent Freedom of Information Act survey carried out by the LGC found that 94 councils had invested at least £2.4 billion in property since 2010 with the aim of specifically using this as a route to generate income. APSE's own research with CIPFA property services found that in 2016 alone around £1billion was invested in property and assets. Accordingly the scaling up of investments by local councils has peaked the interests of the Department for Communities and Local Government, (DCLG) and they have now issued consultation in response, which seeks to amend the prudential framework.

2. About the Prudential Framework

DCLG is the Government department responsible for the Prudential System which reflects the Best Value duties on local authorities to make sensible and prudent borrowing and investment decisions. The framework is given effect by Chapter I of the Local

Government Act 2003 and in the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended. The Prudential Framework includes:-

- The Prudential Code prepared by CIPFA (applying to England, Scotland and Wales)
- The Treasury Management Code prepared by CIPFA (applying to England, Scotland and Wales)
- The Statutory Guidance on Local Authority Investments prepared by DCLG (applying to England [major authorities but also applying to parishes and other smaller authorities if the total of investments exceed set thresholds])
- The Statutory Guidance on Minimum Revenue Provision prepared by DCLG (applying to England and to major authorities only)

It is the latter two elements of the code that are now out for consultation.

3. Why change the Prudential Framework?

The Government is concerned by a number of issues relating to developments in capital investments and reflects in the consultation that the guidance has not been reviewed since the Icelandic banking crash, which impacted on local council investments, and as such a review now, given the current economic conditions, is timely. A primary concern of Government is that local authorities are increasingly reliant upon alternative sources of income but as they invest in markets they are exposed to macro-economic trends, which given the levels of exposure, could leave councils with structural deficits in their budgets. There is also concerns that liquidity should be assured and that liquidity and security of assets investments should be the key considerations over and above that of yield from the asset. Government has also expressed concerns that the type of investments currently being utilised by councils goes beyond their core purpose in delivering services; they have specifically referenced the need for greater transparency in investment decisions and that reporting should outline not just the 'what' but the 'why' as to investment approaches.

The consultation appears designed to address a revised framework that would curtail a form of 'carry trade' whereby councils are borrowing at lower levels of interest, such as through the public works loans board, in order to invest in a development where they can earn back a higher level of interest or yield, generating an income from the asset or development. Whilst this appears to be acceptable for strategies linked, for example to local regeneration, with a demonstrable benefit to the local area, it is termed as 'borrowing in advance of need' whereby this process is utilised for out of area investment. In a clarification statement to the consultation DCLG has stated that

"We do not want to restrict opportunities for local authorities to use commercial structures to kick start local economic regeneration to deliver services more effectively. However, the prime duty of a local authority is to provide services to local residents, not to take on disproportionate levels of financial risk by undertaking speculative investments, especially where that is funded by additional borrowing.

For this reason we are proposing that all local authorities disclose the contribution that each investment makes towards the core objectives of the local authority. The proposals also make it *clear that borrowing solely to fund yield generating investments is borrowing in advance of need. Local authorities will be able to borrow to fund investments that have multiple objectives, including generating yield*."

This appears to suggest that out of area investment will not of itself be completely debarred but that local authorities would need to demonstrate a clear link between the investment and how it contributes to a council's core objectives.

Furthermore DCLG is concerned that reliance upon yield from investments, balanced against servicing any debts occurred as a result, and the risk of over-exposure to markets, could place at risk the Minimum Revenue Provision (MRP) which local authorities are required to calculate as part of the statutory guidance found in section 21(1A) of the Local Government Act 2003.

As local authorities are usually required to set aside some of their revenue as provision for debt incurred in respect of capital expenditure financed by borrowing (or long term credit arrangements) the Government has stated that the MRP guidance needs to be updated.

4. Proposed changes

As a result of the many issues identified in the consultation DCLG has proposed a number of changes which includes:-

- Revised statutory guidance on local authority investments
- Revised guidance on Minimum Revenue Provision

The DCLG consultation is therefore seeking the views of local authorities on the proposed changes. APSE will be responding to these changes on behalf of its member authorities. Therefore APSE members are asked to share their views and any draft responses to ensure APSE's response is reflective of the views of the APSE membership.

The consultation documents can be found here.

5. APSE comment

APSE launched research in the summer of 2017, produced in collaboration with CIPFA property services, which offered guidance to local authorities on the use of asset based investments to generate new sources of income. 'Bricks Mortar Money' demonstrated that councils are already heavily utilising investments as a means to plug the funding gaps as a result of ongoing austerity.

Key findings and recommendations in our report suggested a ten stage approach which includes:-

1. **Establish what you've got**

Local authorities may have acquired a number of properties over a number of years, with some leased to third parties, but not all held for investment purposes; nevertheless some may be incorrectly classified as part of the investment portfolio when in fact they may be held for other purposes, such as regeneration. By establishing the nature of the portfolio councils can explore the balance of the costs of holding properties compared to the income generated. Typically a property investment portfolio would classify its Tenanted Non-Residential Properties (TNRP) as part of that process of review.

2. **Measure costs and performance of existing investment assets**

Where the sole reason for holding an asset (such as a TNRP) is an income return it is important to look at performance measurements such as the costs of energy, maintenance, management and support costs, against the income generated from rentals . By looking at the overall performance, such as maintenance costs potentially passed on to tenants councils can proactively explore what would make a property attractive to potential tenants.

3. **Strategy**

Once you have established what you have and how it is performing then this allows the council to determine its strategic priorities; this may include divesting under-performing assets or if the risk appetite is there amongst elected members, guided by appropriate advice, a move towards acquiring further assets. As yields can go down as well as up (as warned in the DCLG consultation).

4. **Geography/Boundaries**

Whilst some local authorities have made conscious decisions to invest outside of their area this is not without risk. Typically by investing in the local area you may be better able to understand local markets, planning and up-coming localities which may produce better yields. Equally investments outside of the area may spread risk across different regions (and thus local economies that perform differently) as well as providing increased choice. However it is clear that DCLG regard this type of out of area investment as potentially falling under the category of 'borrowing in advance of need' and as such this may be an area that is constrained somewhat in the near future or needs to be treated differently.

5. **Funding**

Funding investments may be come from a range of sources though most typically through reserves or through borrowing. As reiterated in 'Bricks Mortar Money' and emphasised in the DCLG guidance and CIPFA's treasury management code, a key consideration needs to be to ensure the security of the principal sum and the liquidity of the asset – it is important to get back the money invested if something goes wrong. The principle would be security, then liquidity then yield with the latter only being considered when the first two have been satisfied. Again the issue of funding is addressed in the DCLG consultation and draft revised guidance.

6. Skills and capacity

There will be different skills sets involved in managing assets, from property acquisitions, opportunity spotting, through to legal advice and treasury management. Where there are gaps in skills and capacity use should be made of professional external advice if necessary or recruiting specialist advisors. However, as with all strategic approaches to issues, there will be a balance between the gains that can be made from investments and the costs of facilitating that investment.

7. Delivery models

Whilst there are legal and tax implications of delivery models these will need to be determined locally however many local authorities self-manage their port-folios or purposefully upskill their existing workforce. Some will invest through an external property fund, helping potentially to spread risk over a number of different investments, and some councils may decide to set up an arms-length company to manage its investments, principally to allow more agile responses to investments that may be otherwise more constrained through cabinet or committee processes. In any scenario however the parameters of activity should in APSE's view be determined by democratically elected councillors.

8. Acquire carefully (Risk Management)

Whilst this is an obvious step, even with a strategic plan for asset management in place, each asset will be unique and should be treated as such. Accordingly it is prudent to have in place a pre-agreed assessment / scoring criteria to guide acquisitions. Councils need to be assured that an asset is right for them.

9. Acquisition and management

As acquisitions and ongoing management of assets is a dynamic area there is an increasing level of delegation to allow for quicker decision making processes. Equally the on-going management of a property, once acquired, may sit separately from standard property maintenance within a council since 'the customer' will be an external tenant and there may be requirements to meet specific service standards, and response times, set out in leases and so forth.

10. Monitor, review and adapt

Again as suggested in 'Bricks Mortar Money' and as DCLG have suggested councils should proactively manage their investment assets and a key area to this is the financial performance; has the anticipated yield been realised? Are markets changing? All of these issues mean that assets for investments should be proactively managed, reviewed and adapted as necessary, over time. DCLG's consultation makes specific reference to performance reporting – not just on yields but overall exposure to risk and being able to demonstrate that the cost of borrowing will not impact on the councils ability to deliver its core services. Thus continually moulding the port-folio to realise the council's objectives is an important element of an approach to proactively managing assets.

6. Conclusions

The current financial climate for local councils has made new sources of income not just attractive, but necessary, to enable councils to continue to provide quality levels of local public services. Whilst it is of course in the public interest to ensure that local authority financial management is proportionate and appropriate, equally any attempts to fetter councils unduly from assets investments, which are now heavily relied upon to deliver an income source, will be problematic.

In some senses councils may feel that the Government is trying to have it all ways; on the one hand continuing austerity budgeting and encouraging councils to move away from reliance on RSG, as well as the purported new freedoms and flexibilities such as the General Power of Competence, but on the other constraining municipal entrepreneurialism. Local councils would suggest that new sources of income generation, including asset investment, is in the over-arching interests of their local communities and the services that they receive. Accordingly APSE would encourage a sensible outcome from the consultation which reflects the financial issues that local government faces alongside a balance of risk management. It is fair to say that the vast majority of councils are already well versed in managing complex investment port-folios and are fully aware of the risks and act with the utmost regard for the long-term financial health of the local authority and local areas.

Bricks Mortar Money can be downloaded free of charge from the APSE Website using this link

Please share your consultation response with Mo Baines, APSE Head of Communication and Coordination by email to mbaines@apse.org.uk

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