Cabinet – 30 January 2019

(Non-Treasury) Commercial Investment Strategy 2019/20

Recommendation of the Cabinet Member for Finance

Report of the Deputy Director of Finance (S151) and Director of Corporate Services

1. That Cabinet approves:

   (a) the (Non-Treasury) Commercial Investment Strategy for 2019/20 and notes the circumstances under which (Non-Treasury) Commercial Investments can be made;

   (b) the Governance arrangements to be put in place for proposing and approving (Non-Treasury) Commercial Investments;

   (c) a maximum quantum for (Non-Treasury) Commercial Investments of £20 million in 2019/20;

   (d) a maximum limit for an individual Service Investment Loan of £10m in 2019/20; and

   (e) that any upwards change in the amounts of the limits specified in Recommendations 1(c) and 1 (d) be delegated to the Deputy Director of Finance (S151) in consultation with the Cabinet Member for Finance.

Introduction

2. The County Council ('the Council') can invest its money for three main purposes:
   - **Treasury Management Investments** – when the Council has surplus cash because of its day-to-day activities i.e. where income is received in advance of expenditure;
   - **Service Investments** – when the Council supports local public services by lending to or buying shares in other organisations; and
   - **(Non-Treasury) Commercial Investments** – where the Council's main purpose is to earn investment income.

3. The Council's treasury management investments are considered as part of the Council's Treasury Management Strategy 2019/20, which is the subject of a separate report and which meets the requirements of the revised *Treasury Management in the Public Services Code of Practice*, published by the Chartered Institute of Public Finance and Accountancy (CIPFA) in December 2017.

4. This (Non-Treasury) Commercial Investment Strategy is a new report for 2019/20 fulfilling the requirements of the statutory guidance issued by the Ministry of Housing, Communities and Local Government's (MHCLG) in its revised *Guidance on Local Government Investments* published in February 2018. It will concentrate on Service Investments and Commercial Investments i.e. the Council's non-treasury

management investments. This Strategy covers County Council matters only and does not include any Pension Fund investments, which are subject to separate governance arrangements.

Treasury Management Investments

5. The Council typically receives income in cash (e.g. from precepts, taxes and grants) and pays for its expenditure in cash (e.g. through payroll and invoices). It might also hold reserves for future expenditure. These activities, plus the timing of long term borrowing decisions can lead to a cash surplus which is invested in accordance with the Treasury Management guidance from CIPFA.

6. The contribution that treasury investments make to the objectives of the County Council is not focussed purely on generating investment income. Whilst yield is an important consideration, it is in support of effective treasury management activities and is therefore secondary in nature to the security and liquidity of those investments.

7. Details of the Council's policies and plans for treasury management activities for 2019/20 are covered in the Treasury Management Strategy, which includes the Annual Investment Strategy.

Service Investments

8. The core function of the Council is to deliver statutory and local public services to local residents and ensure the general wellbeing of the County and those residents. Indeed, the Council's own Vision is for a connected Staffordshire where everyone has the opportunity to prosper, be healthy and happy.

9. Service Investments can be broadly defined as any investments made to support delivery of those statutory and local public services, and the details of many of these are contained within the Capital Strategy for 2019/20, which is the subject of a separate report. However, in terms of the CIPFA guidance on Commercial Investments, these are more specifically defined as Loans or Shares.

<u>Loans</u>

10. The Council can lend money, to third parties, to support local public services and stimulate economic growth.

11. Previously, the Council has lent £150,000 to Nexxus Trading Services Ltd, a company wholly owned by the Council to provide social care services for older people and those with disabilities. The current balance outstanding is £120,000. Whilst this loan is to an organisation with which the Council has strong links, if the Council wanted to make a loan to local organisations, such as suppliers, local businesses, local charities, housing associations, local residents or its employees, it would need to ensure the loan meets service delivery objectives or fulfils one of its roles as a local authority.

12. The principal risk of making service investment loans is that the borrower may be unable to repay the principal lent or the interest due. To limit this risk, the Council will need to consider setting upper limits for each category of borrower and potentially a maximum single loan amount. To provide some flexibility at this early stage, it is

proposed that the maximum single loan amount for 2019/20 be set at £10m but that this be reviewed following the first 12 months of operating this strategy. Consideration will also need to be given to limits by category of borrower and any single loan amount limits within those categories. Proportionality and the covenant strength of the borrower will also need to be considered. E.g. Local Business relative to Local Charity relative to an Employee.

13. Any request for a service loan will be considered on its own merits. The Council will need to undertake a full risk assessment before making a service loan and continue to assess the covenant strength of the borrower, during the full term of the loan. The risk assessment will consider, but not be limited to, the following:

- Assessment of the market and the borrower including:
    i. the nature and level of competition in that market;
    ii. how the market and borrower's needs will evolve over time;
    iii. any barriers to entry or exit to that market; and
    iv. any ongoing investment needs for the borrower.
- Whether and how the Council will use external advisors
- How the quality of advice from the external advisor will be monitored and maintained.
- To what extent credit ratings have been used.
- Where credit ratings are used, how they are monitored and the procedures for taking action if credit ratings change.
- What other sources of information are used to assess and monitor risk.
- Any security that might be required.

14. Where service loans are made, the Council will make every reasonable effort to ensure the full amount lent is repaid and will have appropriate credit control arrangements in place to recover overdue payments. Accounting standards still require the Council to set aside loss allowances for any likelihood of non-payment. The Council will report the balance owed less any loss allowance in its statement of accounts.

Shares

15. The Council can invest in the shares of a third-party organisation to support local public services and potentially stimulate local economic growth.

16. Prior to the new guidance being issued, the Council already owned 49% of the shares in Entrust and Capita Business Services Limited, a subsidiary of Capita plc. Entrust provide education support services to local schools, so this investment clearly aligns itself to the Council's service delivery objectives i.e. the running operations of schools in Staffordshire.

17. The main risk of investing in shares is that they may fall in 'market value' meaning that the initial outlay may not be recovered, if there was ever a need to sell the shares. The Council's shares in Entrust were valued at £1.7m at 31 March 2018 and although the value of the Council's service investment shares in Entrust has fallen significantly, the investment continues to contribute to the Council's service delivery objectives.

18. To try to limit that risk in the future, and as part of this strategy, the Council will need to consider setting upper limits on the amount that can be invested in each category

of shares. No limits are being suggested for 2019/20, as any investment proposal will need to be considered fully prior to being presented to Cabinet for their decision.

19. Any request to invest in the shares of a company for service purposes will be considered on its own merits. The Council will need to undertake a full risk assessment before making such an investment and will also need to continue to assess the financial strength of the company whilst it remains invested in those shares. The risk assessment will consider, but not be limited to, the following:

- Assessment of the market and the investment company including:
    - i. the nature and level of competition in that market;
    - ii. how the market and the investment company's needs will evolve over time;
    - iii. any barriers to entry or exit to that market; and
    - iv. any ongoing investment needs for the company.
- Whether and how the Council will use external advisors.
- How the quality of advice from the external advisor will be monitored and maintained.
- To what extent credit ratings have been used.
- Where credit ratings are used, how they are monitored and the procedures for taking action if credit ratings change.
- What other sources of information are used to assess and monitor risk.

20. For liquidity purposes, for both types of Service Investments, which fall outside the Capital Strategy, the Council will need to put in place procedures to determine how the Council will stay within any Approved Limits and also the maximum investment duration permitted for investments. Initially, for 2019/20 with very few service investments anticipated, it is proposed that this be incorporated into the risk assessment of the individual loan or share proposals, which will be overseen as part of the Governance arrangements described later in this report.

Commercial Investments

21. Under current guidance, the Council is permitted to make commercial investments purely with the intention of making a profit or generating revenue income.

<u>Property and Other Commercial Investments</u>

22. Of late, there has been professional and political challenge to permissions in relation to property investments and very recently, this has resulted in CIPFA issuing a warning to Local Authorities against the practice of borrowing (relatively cheaply) from the Public Works Loans Board (PWLB) and then using these loans to purchase commercial property, outside of the local authority area, purely for financial gain. Prohibitive regulation is also being considered. The Council does not have any such commercial investments in property.

23. Whilst there has been some challenge about borrowing to invest outside of the local area, more acceptable would be investment in property within the local area, particularly where it supports the provision of services. This may be funded through the use of surplus reserves or borrowing (from the PWLB) for capital purposes, where long term reserves are not available.

24. Under the wider commercial investment opportunity, the Council can also invest in non-property related assets such as Equities, Bonds, Land, Timber and Infrastructure, to name but a few asset classes. These may take on multiple investment forms and legal structures such as direct investments, unitised investment vehicles and limited partnerships.

25. Irrespective of location or service purpose, any property investments would be subject to the same risk assessment process as other commercial investments. This will include, but not be limited to, the following:

- Assess the market and the investment specifics including:
    i. the nature and level of competition in that market;
    ii. how the market and the investment will evolve over time;
    iii. any barriers to entry or exit to that market; and
    iv. any ongoing investment needs for the asset class.
- Whether and how the Council will use external advisors.
- How the quality of advice from the external advisor will be monitored and maintained.
- To what extent credit ratings have been used.
- Where credit ratings are used, how they are monitored and the procedures for taking action if credit ratings change.
- What other sources of information are used to assess and monitor risk.

26. Property has additional risk considerations in terms of valuation, income and liquidity:

- The market and accounting valuations may be lower than the purchase cost (including taxes and transaction costs) and this may have revenue account consequences;
- Rental income is dependent on having a tenant and the ability of that tenant (covenant) to make payment; and
- Properties can be difficult to sell and convert to cash at short notice, especially in certain market conditions.

<u>Loan Commitments and Financial Guarantees</u>

27. Whilst not investments per-se, as no money has exchanged hands, loan commitments and financial guarantees are referenced for completeness as they carry similar risks to investments.

28. To date, the Council has not made any commercial investments. Therefore, 2019/20 will be a year in which consideration will be given to the available opportunities and how they might be aligned with investment in the County and the public services the Council needs to provide. As part of that process, should individual investment proposals warrant being considered further, they will be reviewed in accordance with the Governance arrangements described later in this report.

Quantum, Proportionality and Diversification

29. Guidance recommends that if a Local Authority plans to become dependent on profit generating investment activity to achieve a balanced revenue budget, then it must show the extent of that dependency as part of this report. Contingency plans, for that Authority, if it fails to achieve the expected net profits, should also be outlined.

30. Whilst the Council does have a few Service Investments in the form of 1 loan and some shares which generate a small profit and whilst the Council is open to reviewing its approach to determine whether income from investments can be improved, the Council is not currently, nor does it plan to become, dependent on profit generating investment activity to achieve a balanced revenue budget. However, it is considered good practice and good risk management to consider the Council's exposure to commercial investments in terms of total exposure, single investment exposure and diversity of investments.

31. In 2019/20, as the potential for Commercial Investments is explored further, it is proposed that, initially, total exposure should be capped at £20m. Whilst it would be beneficial to also limit the amount on any single investment, thus forcing diversification, (i.e. a £5m single investment limit would mean a minimum of 4 investments) it is considered impractical to do so in the early stages of building up any commercial investment portfolio. However, this will need to be kept under review.

Borrowing in Advance of Need

32. As referred to previously, Government guidance states that local authorities must not borrow more than or in advance of their needs, 'to profit from the investment of the extra sums borrowed'. To date, the Council has not borrowed in advance of need for this purpose. When the Council did borrow in advance of need or if it is likely to need to do so in the future, then this would only be to fund the borrowing requirement for the capital programme; particularly if future borrowing rates were expected to increase. The reasons for such would be explained as part of this suite of reports. The Council would also outline its policies for managing the risks of investing the money borrowed in advance of need e.g. not achieving the desired profits or the impact of a change in borrowing rates.

Governance, Capacity, Skills and Culture

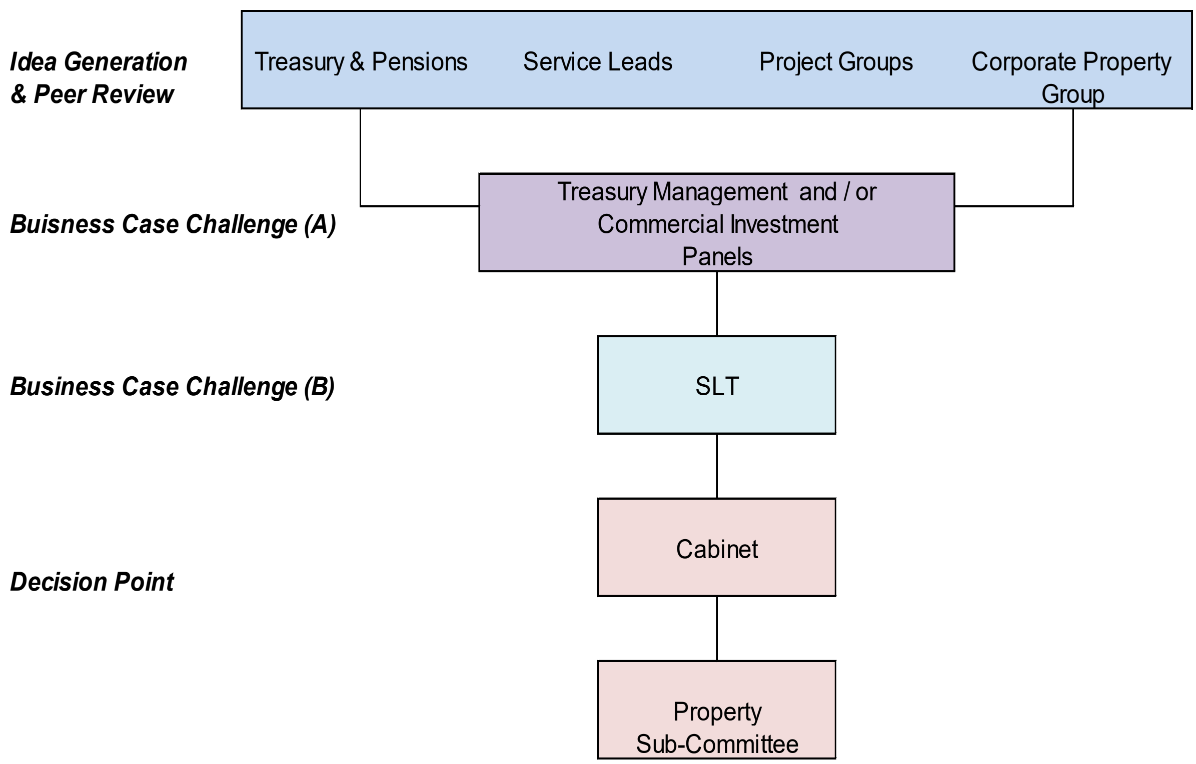
33. The Council will need to ensure that Elected Members and Officers involved in the investment decision making process have the appropriate capacity, skills and information. Those involved in the investment decision making process should:
- Take informed decisions about whether to enter into a specific investment;
- Assess individual investments in the context of the strategic objectives and risk profile of the Council; and
- Understand how their investment decisions can change the risk exposure of the Council.

34. Elected Members and Officers involved in negotiating commercial deals for the Council should be aware of the core principals of the prudential framework and of the regulatory regime within which the Council operates. Whilst much of this has been covered in the body of this suite of reports, other things, such as procurement regulations will also need to be considered.

35. Whilst idea generation will not be exclusive, the Council will need to make sure it has Corporate Governance arrangements in place to ensure accountability, responsibility and authority for decision making on investment activities within the context of the Council's corporate values. The following chart illustrates how this might work within the current Corporate Governance arrangements albeit it is recognised that this may need to change as the Council's awareness and involvement in commercial

investment activity evolves. The Scheme of Delegation, and any relevant sub-schemes, may also need to change to reflect any new arrangements going forward.

Commercial Investment Governance Framework



36. It is anticipated that Investment Advisors will be used at some stage of the Governance process, not only to bring relevant investment expertise and information but also to introduce independent challenge into the process. The cost of using Advisors will need to be taken into account in any analysis of forecast net investment returns.

37. A Business Case, in an agreed form, but covering such details as that provided in Appendix 2 will need to be submitted by the initiator of the Investment to facilitate peer review and challenge. As well as a descriptor of the Commercial Investment opportunity, the Business Case will need to demonstrate its alignment to the Council's Vison and Priorities as well as any service delivery considerations. Key areas of the Business Case will include and demonstrate:

- Details of Investment
- Background (including the Service Objective being fulfilled)
- Due Diligence Undertaken
- Financial and Legal Implications
- Risk and Risk Management

Investment Indicators

38. As part of its routine reporting, and in addition to the various investment limits the Council should also consider setting quantitative indicators to assess its commercial investment decisions. As a minimum these should include the Council's Total Risk Exposure, Investment Funding and the Net Investment Rate of Return. Again,

indicators will need to be developed as part of working practices as the Council's Commercial Investment activities gain momentum. An illustration of how these Indicators might be constructed is provided in Appendix 3.

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List of background papers

1. Statutory Guidance on Local Government Investments (3rd Edition) – Issued under Section 15(1)(a) of the Local Government Act 2003 and effective for financial years commencing on or after 1 April 2018.
2. Treasury Management in the Public Services: Code of Practice (CIPFA) (2017)
3. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2017)
4. Local Authorities (Capital Finance and Accounting) Regulations 2003
5. Localism Act 2011 – Guidance on the General Power of Competence in sections 1 to 6.

Appendix 1

Equalities implications: There are no equalities implications.

Legal implications: Approval of Prudential Indicators and a Commercial Investment Strategy is necessary to meet the requirements of the Local Government Act 2003.

Resource and value for money implications: All resource implications are covered in the body of this report which links to the County Council's MTFS, Capital and MRP Strategy and Treasury Management Strategy for 2019/20.

Risk implications: Risk is inherent in Commercial Investment and is dealt with throughout the report.

Climate change implications: There may be climate change implications arising from commercial investment decisions. These will be highlighted as part of any Business Case.

Health impact assessment screening: There are no direct health impact assessment implications arising from this report.

Appendix 2

STAFFORDSHIRE COUNTY COUNCIL

COMMERCIAL INVESTMENT BUSINESS CASE

Illustration of areas to be considered

A **Details of Investment**

1. Name of Investment
2. Proposed Investment / Price £
3. Brief Description of Investment
4. Form and Legal Structure of Investment
5. Forecast Net Investment Return (Capital and Annual Income)
6. Investment Period
7. Investment Management Fees / Developer Profit

B **Background**

1. Reason for proposing Investment
2. Service Objective fulfilled
3. Social Impact
4. Funded from
5. Fit with other Investments / Strategy (Diversification)

C **Due Diligence Undertaken**

1. Investment Advisors / Managers
2. Structure of Company and People involved in the Investment
3. Process for Investment decision making
4. Underlying Investment Philosophy
5. Performance of previous similar Investments
6. Price

D **Financial Implications**

1. Yield
2. Capital / Income Return Targets
3. Source of Funding
4. Borrowing in Advance of Need
5. Commitment, drawdown, investment periods
6. j-curve
7. Payback period
8 Exit Penalties
9. MRP
10. International Financial Reporting Standard 9 – Financial Instruments
11. Fees

E **Environmental, Social and Governance Implications**

1. Positive / Negative factors
2. Legality

F **Risk & Risk Management**

1. Security Risk
2. Investment Risk
3. Liquidity Risk
4. Development Risk
5. Counterparty Risk
6. Reputational Risk
7. Compliance Risk
8. Operational Risk
9. Regulatory Risk
10 Interest Rate Risk
11. Market Risk
12. Currency Risk
13. Non-Systematic Risk (Diversification)

G **Legal Implications**

1. Form and Structure of Investment
2. Documents
3. Anti Money Laundering / Know Your Customer
4. Indemnities
5. Conflict of Interest

H **Procurement Implications**

1. Procurement Route followed
2. Exemptions received

Governance

Peer Review undertaken:

Comments:

Business Case Challenge (A) TMP / CIP undertaken:

Comments:

Business Case Challenge (B) SLT undertaken:

Comments:

Recommendation to Cabinet / Property Sub- Committee:

Appendix 3

COMMERCIAL INVESTMENT INDICATORS

Total Risk Exposure

This demonstrates the Council's total exposure to potential investment losses.

Total investment exposure	31 March 18 Actual £m	31 March 19 Forecast £m	31 March 20 Forecast £m
Treasury management investments			
Service investments: Loans			
Service investments: Shares			
Commercial investments: Property			
TOTAL INVESTMENTS			
Commitments to lend			
Guarantees issued on loans			
TOTAL EXPOSURE			

Investment Funding

The Council's investments may be funded by borrowing and /or the use of reserves, capital receipts, grants, developer contributions etc. These will be itemised appropriately.

Net Investment Rate of Return

This indicator shows the investment income received less the associated costs (including the cost of borrowing if appropriate), as a proportion of the sum initially invested. Under the local government accounting framework, not all gains and losses affect the revenue account in the year they are incurred.

Net Investment Rate of Return	2017/18 Actual	2018/19 Forecast	2019/20 Forecast
Treasury management investments			
Service investments: Loans			
Service investments: Shares			
Commercial investments: Property			
ALL INVESTMENTS			