BABERGH DISTRICT COUNCIL and MID SUFFOLK DISTRICT COUNCIL

From: Head of Corporate Resources	**Report Number: JAC54**
To: Joint Audit and Standards Committee	**Date of meeting: 15 June 2015**

CAPITAL INVESTMENT STRATEGY

1. Purpose of Report

1.1 To outline the approach being taken to the Capital Investment Strategy in both the short and medium/long term and its links to the Medium Term Financial Strategy.

1.2 To seek approval from Councillors to amend the Treasury Management Strategy for 2015/16 to make financial investments that will generate additional revenue for the two Councils.

2. Recommendation

2.1 That the Capital Investment Strategy approach and its impact in both the short and medium/long term be noted.

The Committee is able to resolve this matter

3. Recommendation to Executive/Strategy Committees and both Councils

3.1 That the 2015/16 Treasury Management Strategy be amended as outlined in paragraph 9.31.

4. Financial Implications

4.1 As outlined in paragraphs 9.27 and 9.30 of the report.

5. Risk Management

5.1 Key risks are set out below:

Risk Description	Likelihood	Impact	Mitigation Measures
Loss of investment	Unlikely	Bad	Diversification of investments to limit the impact and acting on advice from treasury management advisers
Return on investments is lower than anticipated	Unlikely	Noticeable	Investment performance is kept under review and changed where practicable
Higher than expected borrowing costs	Unlikely	Noticeable	Borrow from Public Works Loan Board (PWLB) at a fixed rate for greater certainty

6. Consultations

6.1 The proposals put forward in this report have been fully discussed with the Councils' treasury management advisers, Arlingclose.

7. Equality Analysis

7.1 This is a technical report, so none of the groups with protected characteristics are affected by the contents and hence no equality analysis has been undertaken.

8. Shared Service / Partnership Implications

8.1 This is a joint report for Babergh and Mid Suffolk. The recommendations are the same for both Councils, but may be implemented in different timescales.

9. Background Information

Strategic Context

9.1 In February 2015 Babergh and Mid Suffolk District Councils approved the Joint Medium Term Financial Strategy (MTFS). The MTFS outlines the challenges facing the Councils over the coming years. The strategic response to those challenges, to ensure long term financial sustainability is set out in six key actions:

a) Aligning resources to the Councils' new strategic plan and essential services

b) Continuation of the shared service agenda, collaboration with others and transformation of service delivery

c) Behaving more commercially and generating additional income ("profit for purpose")

d) Considering new funding models (e.g. acting as an investor)

e) Encouraging the use of digital approaches for customer access

f) Taking advantage of new forms of local government finance (e.g. new homes bonus, business rates, challenge award funding)

9.2 To set balanced budgets for 2015/16, Babergh is using £1.8m out of £2m received from New Homes Bonus (NHB) and business rates grant funding and Mid Suffolk is using £0.5m out of £2.5m received.

9.3 The details within the Joint MTFS show that for Babergh the additional funding gap for 2016/17 is approximately £1m and for Mid Suffolk it is £0.75m against a budget requirement of approximately £10m for each Council. Over the next three years the total additional funding gap is estimated to be £2.5m for Babergh and £2.3m for Mid Suffolk.

9.4 The future of NHB funding is still uncertain following the general election. If the Councils wish to change their funding model over the period to 2018/19, to eliminate reliance on NHB funding, then additional annual income or cost savings will have to be found to the total value of £4.3m for Babergh and £2.8m for Mid Suffolk.

9.5 The Babergh position for 2016/17 is indicating that if NHB and business rates grant funding continue in their current format, this is extremely unlikely to be sufficient to bridge the anticipated funding gap. The position is different for Mid Suffolk where NHB and business rates grant could be used to fund the gap.

<u>Response to the Strategic Context</u>

9.6 When the budget was agreed for 2015/16 each Council agreed an allocation of £25m in their capital programme in order to be able to take advantage of capital investment opportunities that would generate income. At the same time both councils resolved that any use of the £25m would be approved by business cases being presented to Executive / Strategy Committee for onward recommendation to Council.

9.7 Since the budget was approved, a team of officers has been established with finance, property, legal and investment experience and specialist advice has been taken from the Councils' treasury management advisers, Arlingclose, to begin to look at opportunities for investment.

9.8 From an early discussion with Arlingclose it became evident that there are two ways that the Councils can generate income:

a) The first is by ensuring that the councils' cash (arising from the daily cash flow position) is being invested in such a way that maximises the return compared to an acceptable level of risk.

b) The second relates to how the councils use their capital resources to enable delivery of both the medium term financial and corporate objectives i.e. delivery of more homes and jobs for our communities plus a revenue return.

The former can be implemented in the short term, whilst the latter is more complex and will need to be developed over the medium to long term.

9.9 The Capital Investment Strategy's immediate focus has therefore been on what can be achieved in the short term, to contribute towards the funding gap for 2016/17. At the same time officers are beginning to consider opportunities for the medium to long term that will generate revenue to bridge the funding gap in the years beyond 2016/17.

9.10 External legal advice is being sought to ensure that there is clarity about how the Councils can use their capital resources to generate a revenue return in the medium to long term before any proposals are brought forward. Local authorities cannot borrow purely to invest for a financial return.

<u>Cash Investment Opportunities</u>

9.11 The two Councils predominantly invest their cash in highly rated financial institutions, money market funds or the Government in accordance with the approved Treasury Management Strategy. This strategy achieves an average return on those investments roughly in line with the Bank of England base rate, which currently stands at 0.5%.

9.12 Officers have been discussing with Arlingclose what other options are available for the investment of the Councils' cash in order to achieve a higher return. Following these discussions and exploratory visits, two options are now being put forward for the consideration of Councillors as follows:

a) Churches, Charities and Local Authorities Property Fund (CCLA)

b) Funding Circle

9.13 The ability to invest in these options is already contained within the existing Treasury Management Strategy for 2015/16, but approval is being sought to increase the current limits for these category of investments. The two options and the changes that need to be made to the existing Treasury Management Strategy are outlined in more detail below.

<u>CCLA Property Fund</u>

9.14 CCLA is a specialist fund manager that only works for charities and local authorities and manages a local authority property fund. The fund has been in existence since 1971, has about 100 local authority investors, a total fund value of approximately £350m and currently manages about 30 properties. A fund such as this has the advantage of providing diversification of investment risks, coupled with the services of a professional fund manager, in return for a fee. The average yield of the fund over the last 7 years has been in the 4 - 6% range and as at April 2015 was running at 4.8%.

9.15 The fund has the advantage of offering a reasonably consistent income level, which is a primary consideration for the short term, but also offers the opportunity for capital growth over the medium to long term. It should be remembered however that property values can decrease as well as increase.

9.16 The fund should be viewed as a longer term investment (3 years minimum), so the money could not be accessed at short notice to solve short term cash flow issues. This is because there is approximately a 7% difference between the offer (the buying) and bid (the selling) price for units in the fund. The Councils therefore need to ensure that the money is available to invest longer term. A possible consequence of this is that the Councils may have to borrow short term for cash flow purposes. Borrowing of this nature is not unusual, Mid Suffolk currently has to borrow on a regular basis to maintain a cash break-even position within its bank accounts, but the cost of such (interest at approximately 0.5%) will need to be factored in.

<u>Funding Circle</u>

9.17 Funding Circle is the leading global peer to business lender. It was established in 2010 and has employees in both the US and UK. The UK arm has funded loans of £600m to over 7,000 small and medium enterprises (SME's). They are arranging loans of approximately £40m per month, up to a maximum of £3m per business and the value of loans is tripling year on year. The Government has invested sums of £20m in 2013 and £40m in 2014.

9.18 Businesses, sole traders or limited companies, have to have been trading for at least 2 years (average 8 years) and are assessed into risk ratings of A+ to C-. They go through a three stage credit process before they are accepted and are then closely monitored by Funding Circle. Loans are secured with personal guarantees or other security e.g. assets.

9.19 As at April 2015 there were 14 local authorities investing a total of approximately £4m in Funding Circle. If risk is spread nationally across the ratings A+ to C- then average net returns after bad debts are operating in the 6 – 8% range.

9.20 Funding Circle, like CCLA, should be viewed as a longer term investment. Money will be recycled to the Councils, as loans are repaid by the businesses, but to maintain the revenue return this will need to be reinvested in other businesses.

9.21 The other advantage of Funding Circle is that investments can be targeted at geographic areas. Whilst this increases the risk of default and is likely to generate a lower investment return it can have other benefits of assisting businesses within a local area to stimulate economic growth. This element would need to be investigated further, but there is the potential to target some funding in this way.

Risk and Reward

9.22 The current practice for investments is an extremely low risk strategy for the councils. The two options discussed above are already contained within the existing Treasury Management Strategy for 2015/16, so are seen as an acceptable level of risk by Arlingclose, but by their nature are slightly higher risks than current practice. The higher risk comes with the advantage of a significantly better return on the sums invested, but is still a significantly lower risk than investing in stocks and shares.

Funds Available and Potential Return

9.23 Local authorities are able to borrow externally up to the limit of their Capital Financing Requirement (CFR). A number of Councils reduce their external borrowing by using internal funds such as reserves and capital receipts because in recent years, with the low base rate, it has been cheaper to forego the interest earned on investments rather than pay external borrowing costs. Both Babergh and Mid Suffolk are internally borrowed, so this could be replaced by external borrowing, to allow investment in funds such as CCLA and Funding Circle.

9.24 Mid Suffolk has greater internal borrowing of the two Councils, so to make long term investments the Council would need to replace internal borrowing with external borrowing. This would reduce the net gain achieved by investing in the two options as the additional borrowing costs would have to be taken into account. Despite this Mid Suffolk could still derive some financial benefit.

9.25 Babergh is less internally borrowed than Mid Suffolk and has a steady portfolio of cash investments that could be redirected towards funds such as CCLA and Funding Circle to achieve a higher return. The benefit to Babergh would be greater than Mid Suffolk because no additional borrowing costs would be incurred.

9.26 Once the Statement of Accounts has been finalised for each Council for 2014/15 the balance sheet position as at 31st March will inform how much is available for investment. Recent figures suggest that each Council could make long term investments in funds such as CCLA and Funding Circle of up to £10m.

9.27 Taking a fairly prudent average return of 5% on £10m would give Babergh additional net annual income of £450,000 (5% less 0.5% currently received). For Mid Suffolk it would be a lower figure and would depend upon the period over which internal borrowing was replaced with external borrowing. It is anticipated that a net 2.5% could be gained which would achieve additional annual income of £250,000.

9.28 The funds available for investment will be a combination of General Fund and Housing Revenue Account (HRA) resources. It is unlikely that all of the additional income referred to above could be credited to the General Fund and hence contribute to bridging the funding gap, so officers are currently seeking legal advice as to the basis on which the revenue return should be shared between the two.

<u>Investment Proposal</u>

9.29 As outlined in 8.26 above, long term investments of up to £10m could be made by each Council. Following the advice of Arlingclose, that long term investments should be diversified over a number of funds, it is proposed that each Council considers investment of up to £1m in Funding Circle and £5m in CCLA and that further options are explored for the remaining £4m.

9.30 Assuming a rate of return of 5% for CCLA and 7% for Funding Circle the net additional income from £6m of investments for Babergh (after loss of current interest at 0.5%) would be £290,000 and for Mid Suffolk (after borrowing costs of 2.5%) would be £170,000. These amounts may reduce slightly by interest that will need to be paid for any short term cash flow borrowing that may be required. Further income will be generated when the remaining £4m is invested.

<u>Changes to the Treasury Management Strategy</u>

9.31 In order to make the level of investments referred to in paragraph 8.29 above, some changes will need to be made to the current Treasury Management Strategy for 2015/16. The Joint Audit and Standards Committee will need to put forward recommendations to Executive and Strategy Committees, who in turn will make recommendations to Full Council for approval. The changes to be approved for each Council are:

a) Pooled funds increase from £2m per fund to £5m (to cover CCLA)

b) Total investments without credit ratings increase from £2m to £10m (to cover CCLA, Funding Circle and other funds identified for investment)

c) Total non-specified investments increase from £5m to £10m (to cover CCLA, Funding Circle and other funds identified for investment)

d) Loans to unrated corporates increase from £500k in total to £1m in total (to cover Funding Circle – the current limit of £50,000 / 5 years per unrated corporate will be unchanged)

9.32 Once the changes to the Treasury Management Strategy have been approved by both Councils, the Section 151 Officer (Head of Corporate Resources) will have delegated powers to enter into the arrangements with CCLA, Funding Circle and any other funds that are identified. For Funding Circle this will involve agreeing the mix and size of loans in order to diversify the risk. This will be done with the advice of Arlingclose and also discussion with the Finance and Resources Portfolio Holders.

9.33 The timing of investments will differ between the two Councils because Babergh's greater need to generate additional revenue for 2016/17 will take priority and Mid Suffolk will need to replace internal borrowing with external borrowing before any long term investments can be made.

10. Background Documents

10.1 Joint Treasury Management Strategy 2015/16 approved by Councils in February 2015 (Paper P100R in Babergh and X/09/15R in Mid Suffolk)

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