Isle of Wight Council

INVESTMENT STRATEGY

2020-21

Document Information

Title: Status:	Investment Strategy 2020-21 FINAL
Current Version:	2.3
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Consultation:	*Treasury Management Group*
Approved by: Approval Date:	*Full Council* *26 February 2020*
Review Frequency: Next Review:	Annual February 2021

Version History		
Version	Date	Description
1.0	14 January 2020	First draft – template review
1.1	11 February 2020	JMT review
2.1	12 February 2020	S151 officer review
2.2	13 February 2020	Revised capital, investment and MRP policies
2.3	14 February 2020	Final s151 review

Contents

1 Introduction

1.1 The council invests its money for three broad purposes:

1.1.1. 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),

1.1.2. to support local public services by lending to or buying shares in other organisations (service investments), and

1.1.3. to earn investment income (known as commercial investments where this is the main purpose).

1.2 This investment strategy meets the requirements of statutory guidance issued by the government in January 2018 and focuses on the second and third of these categories.

2 Treasury Management Investments

2.1 The council 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. 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 average £9.7 million during the 2020/21 financial year.

2.2 **Contribution**: The contribution that these investments make to the council's objectives is to support effective treasury management activities.

2.3 **Further details**: Full details of the council's policies and its plan for 2020/21 for treasury management investments are covered in a separate document, the treasury management strategy.

3 Service Investments: Loans

3.1 **Contribution**: The council lends money to local businesses to support local public services and stimulate local economic growth, and in the past small loans have been made to local residents. These include loans for, but are not limited to, a sustainable energy generation scheme, the promotion and development of housing affordability, the promotion of tourism, and the development of local employment and regeneration.

3.2 **Security**: 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 council, upper limits on the outstanding loans to each category of borrower have been set as follows:

Table 1: Loans for service purposes

Category of Borrower	31.03.2019 actual			2020/21
	Balance owing £m	**Loss allowance £m**	**Net figure in accounts £m**	**Approved limit £m**
Subsidiaries	-	-	-	20.0
Local businesses	3.1	-	3.1	10.0
TOTAL	**3.1**	**-**	**3.1**	**30.0**

3.3 Accounting standards require the council to set aside a loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the council's statement of accounts are shown net of this loss allowance. However, the council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.

3.4 **Risk assessment:** All loan applications are subject to a business case which is assessed as to how it contributes to the council's corporate plan objectives and then it is presented to Cabinet for their approval. Whilst the council does not have any explicit credit criteria, once this approval to the business case has been obtained, proper due diligence is undertaken, using third party external advisors if there is insufficient staff knowledge and skills. That due diligence will include an evaluation of the company's financial standing using standard ratio analysis as well as an in-depth analysis of future financial forecasts using principles such as Debt Service Cover Ratios and other techniques such as sensitivity analyses. Finally, following the completion of the due diligence the Director of Finance and Section 151 Officer will confirm whether the loan will proceed.

4 Service Investments: Shares

4.1 **Contribution**: The council invests in the shares of local organisations that meet the council's strategic objectives, especially in the areas of sustainable energy and social housing.

4.2 **Security**: One of the risks of investing in shares is that they fall in value meaning that the initial outlay may not be recovered. In order to limit this risk, upper limits on the sum invested in each category of shares have been set as follows:

Table 2: Shares held for service purposes

Category of Company	31.03.2019 actual			2020/21
	Balance owing £m	**Loss allowance £m**	**Net figure in accounts £m**	**Approved limit £m**
Subsidiaries	-	-	-	10.0
Suppliers	-	-	-	2.0
Local businesses	-	-	-	2.0
TOTAL	**-**	**-**	**-**	**14.0**

4.3 **Risk assessment**: All investments in shares are subject to a business case which is assessed as to how it contributes to the council's corporate plan objectives and then it is presented to Cabinet for their approval. Whilst the council does not have any explicit credit criteria, once this approval to the business case has been obtained, proper due diligence is undertaken, using third party external advisors if there is insufficient staff knowledge and skills. That due diligence will include an evaluation of the company's financial standing using standard ratio analysis as well as an in-depth analysis of future financial forecasts using principles such as Debt Service Cover Ratios and other techniques such as sensitivity analyses. Finally, following the completion of the due diligence the Director of Finance and Section 151 Officer will confirm whether the investment will proceed.

4.4 **Liquidity** Any investment in shares would be undertaken for the purpose of regeneration, the provision of additional employment or affordable housing which are all for long term investment and are not subject to liquidity considerations.

4.5 **Non-specified Investments**: Any investment not meeting the definition of a specified investment is classed as a non-specified investment. The council does not intend to make any investments denominated in foreign currencies.

4.6 Shares are the only investment type that has been identified by the council that it is proposed to undertake. The limits above on share investments are therefore also the council's upper limits on non-specified investments. The council has not adopted any procedures for determining further categories of non-specified investment since none are likely to meet the definition.

5 Commercial Investments: Property

5.1 **Contribution:** The council invests in UK commercial property with the intention of making a return that will be spent on local public services.

Table 3: Property held for investment purposes

Property	Actual	31.03.2019 actual		31.03.2020 expected	
	Purchase cost £m	Gains or (losses) £m	Value in accounts £m	Gains or (losses) £m	Value in accounts £m
Salford	11.4	(0.5)	10.9	-	10.9
Aylesford	9.2	(0.6)	8.6	-	8.6
Oxford	10.6	(0.6)	10.0	-	10.0
Southampton	3.9	(0.4)	3.5	-	3.5
TOTAL	**35.1**	**(2.1)**	**33.0**	**-**	**33.0**

The properties were all acquired during the year 2018-19. The acquisition of commercial properties required substantial transaction costs of £2.1 million, including legal and stamp duty fees, which under proper accounting practices are allowed to be capitalised. These costs have not increased the market value of these properties so had resulted in a valuation loss during financial year 2018/19. These assets are required to be valued annually in accordance with CIPFA Code of Practice, with the next valuation in March 2020; there is no evidence to suggest the value is likely to change.

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

5.3 A fair value assessment of the council's investment property portfolio has been made in the past twelve months and the underlying assets provide security for capital investment. Should the 2019-20 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 through the annual report on the performance of the commercial property investment portfolio detailing the impact of the loss on the security of investments and any revenue consequences arising therefrom.

5.4 **Risk assessment:** The council assesses the risk of loss before entering into and whilst holding property investments by applying the principles laid out in TMP13 Non-Treasury Investment Practices. These include the assessment of the financial strength of any tenants and good portfolio management in order to mitigate the risks.

5.5 **Liquidity**: 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. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed, the council has produced a commercial investment strategy which can be found here which details out the procedures to mitigate this risk.

6 Loan Commitments and Financial Guarantees

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

6.2 The council has not held any loan commitments or financial guarantees since April 2019, and has no plans to undertake any new commitments or guarantees in the period of this strategy.

7 Proportionality

7.1 The council plans that profit generating investment activity will assist in achieving a balanced revenue budget. Table 4 below shows the extent to which the expenditure planned to meet the service delivery objectives is dependent on achieving the expected net profit from investments over the lifecycle of the Medium Term Financial Strategy.

Table 4: Proportionality of Investments

	2019/20 Forecast £m	2020/21 Budget £m	2021/22 Budget £m	2022/23 Budget £m
Net Service expenditure	152.3	158.9	157.9	163.3
Gross Investment income	1.6	1.6	1.7	2.3
Proportion	**1.05%**	**1.01%**	**1.08%**	**1.41%**

7.2 Should the council fail to achieve the expected net profit, the council has contingency plans for continuing to provide these services as described below, recognising however at these low proportions any service impact is likely to be small:

- In general, the council undertakes a review of all financial risks facing the council on an annual basis and plans its overall level of Corporate Contingency and General Reserves accordingly; this enables the council to be able to continue services as planned in the short-term whilst any other remedial or mitigating actions are implemented e.g. such as increasing the council's savings requirements in future years.

- The council maintains a specific earmarked reserve which is being built over time to a level sufficient to provide a safeguard against any difference in the fair value of the assets versus acquisition cost, any potential loss of rental income and future improvement works to properties.

8 Borrowing in Advance of Need

8.1 Government 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 council is mindful of this guidance and has taken a risk based proportionate decision to continue with its proposals for commercial property investment (but only up to the borrowing limit approved prior to the introduction of the guidance - see below) where those investments meet very specific criteria. The key reasons for continuing to pursue such a strategy are:

- The council had previously approved and borrowed funds for its existing investments to enable the purchases of commercial investments within a £100 million portfolio.

- It's acquisitions to date were predicated on a whole portfolio amounting to £100 million. Should the council cease its investment plans, the council would be left with an investment portfolio that was not appropriately balanced in terms of the value of the assets held (i.e. too large in relation to the size of the overall portfolio) and not adequately risk diversified across geography or economic sector.

- The council has strict criteria for the acquisition of properties which are designed with the primary objective to protect the capital sum invested and include:
    - Appropriate value compared to the overall portfolio - ensuring a sufficient number of properties over which to manage risk.
    - Strong covenant strength of occupiers.
    - Well diversified in terms of geographical location and economic sector.
    - Properties of quality construction and flexible design - to minimise the risk of voids.
    - In areas of strong growth locations.
    - Well located in terms of access to the strategic road network.
- The commercial property investment portfolio is an integral part of the council's overall Medium-Term Financial Strategy to deliver £11.5 million of savings over the next 3 years, without the investment income further service reductions will be necessary.

- The council does not intend to increase the size of its commercial property investment portfolio beyond £100 million.

- Once the portfolio is complete, the reliance on its investment income in proportion to Gross Service Expenditure will be relatively small at less than 2.5%.

- An earmarked reserve will exist to guard against any reduction in the fair value of the property assets.

- The council maintains general reserves and contingencies at levels that have been based on all known and expected financial risks and their likelihood of occurrence.

9 Capacity, Skills and Culture

9.1 **Elected members and statutory officers:** The Full Council has agreed the establishment of a commercial property fund. The authorisation of expenditure from this fund has been delegated by the council to the Chief Executive, the Director of Finance and Section 151 Officer and the Cabinet member for Resources and these decisions will only be made once the due diligence has been carried out and reviewed.

9.2 All investments considered for purchase will have to undergo both qualitative and quantitative appraisal in order to determine whether they are suitable to be included into the portfolio. The council has entered into an agreement with Portsmouth City Council to provide the services of their property investment team. This team has private sector fund investment experience and has a network of specialists that are able to provide advice as and when required.

9.3 All property acquisitions require a business case and full financial appraisal. The detailed business case and financial appraisal includes building surveys, environmental surveys and valuations in accordance with the Red Book. In addition, properties are revalued on an annual basis.

9.4 The Commercial Property Portfolio is managed by the property investment team from Portsmouth City Council, who are qualified members of Royal Institute of Chartered Surveyors.

9.5 **Commercial deals:** The property investment team has experience of acquiring commercial property for local authorities, and it is part of their contractual arrangements that their staff have the necessary knowledge and training.

9.6 **Corporate governance:** The council has established a set of Practices (TMP13 Non-Treasury Investment practices) that detail out how the investment in other financial assets and property is to be undertaken.

9.7 On an annual basis the Full Council will receive a Capital Strategy as well as this Investment Strategy, which will detail all the non-treasury investments.

9.8 Every six months the Audit Committee receives a report from the property investment team at Portsmouth City Council in which they provide details of the current portfolio including the current performance as well as looking at the medium to long-term strategy.

9.9 Service investments are not provided with financial performance targets directly. These will contribute towards council objectives such as the provision of affordable housing and additional employment. There will be an inherent benefit in that these will alleviate pressures on other council services such as homelessness which can contribute towards savings targets.

10 Investment Indicators

10.1 The council has 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

10.2 **Total risk exposure**: The first indicator shows the council's total exposure to potential investment losses. This includes amounts the council is contractually committed to lend but have yet to be drawn down and guarantees the council has issued over third-party loans.

Table 5: Total investment exposure

Total investment exposure	31.03.2019 Actual £m	31.03.2020 Forecast £m	31.03.2021 Forecast £m
Treasury management investments	63.4	35.1	13.0
Service investments: Loans	3.1	3.1	5.5
Service investments: Shares	-	-	-
Commercial investments: Property	33.0	33.0	33.0
TOTAL INVESTMENTS	**99.5**	**71.2**	**51.5**

10.3 **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. However, the following investments could be described as being funded by borrowing. The remainder of the council's investments are funded by usable reserves and income received in advance of expenditure.

Table 6: Investments funded by borrowing

Investments funded by borrowing	31.03.2019 Actual £m	31.03.2020 Forecast £m	31.03.2021 Forecast £m
Service investments: Loans	1.4	1.4	3.8
Service investments: Shares	-	-	-
Commercial investments: Property	33.0	33.0	33.0
TOTAL FUNDED BY BORROWING	**34.4**	**34.4**	**36.8**

10.4 **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.

Table 7: Investment rate of return (net of all costs)

Investments net rate of return	2018/19 Actual	2019/20 Forecast	2020/21 Forecast
Treasury management investments	0.53%	0.74%	0.74%
Service investments: Loans	3.98%	3.98%	3.98%
Service investments: Shares	-	-	-
Commercial investments: Property	0.91%	1.82%	1.82%
TOTAL INVESTMENTS	**0.84%**	**1.18%**	**1.67%**

10.5 **Other investment Indicators**: Other indicators that explain the extent that which the Council is exposed to the cost of servicing the debt associated with its investments and the value of debt compared to the value of property assets is describe below:

Debt to Net Service Expenditure
An indicator of the financial strength and ability of the Council to repay its debts. This ratio is falling over time, as the council plans to repay some of its current outstanding debt using existing short term invested cash.

Commercial Income to Net Service Expenditure Ratio:
Represents the reliance by the Council on commercial income to fund services.

Interest Cover Ratio:
Indicates the extent to which the net income from investment properties will cover the debt that financed the properties.

As the commercial property portfolio was acquired throughout 2018-19, the investment income does not represent a full year’s activity. Therefore, the ratio is lower in first year of operation.

Loan to value ratio:
Indicates whether the market value of the properties is likely to be sufficient to repay the debt that financed them.

Table 8: Other investment indicators

Indicator	2018/19 Actual	2019/20 Forecast	2020/21 Forecast
Debt to net service expenditure	175.6%	171.2%	144.6%
Commercial income to net service expenditure ratio	0.20%	0.39%	0.38%
Interest cover ratio	300.0%	500.0%	500.0%
Loan to value ratio	60.6%	60.6%	60.6%