CIPFA

CIPFA Early Access Guidance on Investment Categories

Extract from Prudential Code Guidance

GUIDANCE ON INVESTMENT DEFINITIONS

(Prudential Code Guidance paragraph 66)

Investments for treasury management purposes

1 Treasury management investments are defined by the Code as those that ‘arise from the organisation’s cashflows or from its treasury risk management activity’. Taking each in turn:

2 Treasury investments will arise from net cashflows into the organisation. These are unavoidable at the point when the cashflow arrives for treasury officers to deal with. Treasury management aims broadly to balance the organisation’s cashflows daily by borrowing or investing as required.

- Investments for managing cashflows should only be taken for the period until future net cashflows out need to be met; if the investments are deliberately taken for a longer period it suggests a different purpose which is not about managing cashflows efficiently at minimum risk.
- The need to invest is determined by actual and forecast cashflows, not by the value of particular balance sheet items such as useable reserves or the CFR. “Externalising” the CFR or useable reserves is not a justification to borrow and reinvest the proceeds, if the proceeds are unlikely to be needed to meet expected cashflows in the medium term. An authority which is a net borrower only needs to externalise the investment of its useable reserves if it expects the reserves may need to be used, and to result in a forecast net cash outflow for the authority overall. In that case, the investment ought to be in short term deposits of high credit quality, given the possibly imminent use. Cashflows should be aggregated for treasury management purposes, and the net cashflow position borrowed or invested accordingly (as required by the Treasury Management Code, TMP8). Individual balance sheet balances should not be treated as isolated investment pots regardless of other balances and cashflows, unless statutory or regulatory requirements require otherwise.

3 Treasury investments may also arise from the authority’s treasury risk management activity. This refers to treasury risk management operations where borrowing may result in investments being held. The purpose of risk management operations is primarily to limit treasury risks rather than to seek financial profit from investment. The main examples of this are:

    - Authorities may prudently borrow in order to maintain an adequate (but not excessive) level of liquidity to meet unexpected cashflows. Investments taken for this purpose will be in short term deposits of high credit quality.

- Authorities may also prudently borrow to fund forthcoming planned cashflows in, say the next one to three years, and any temporary investments resulting should be at appropriate maturities to meet the forecast net cash outflow. The Treasury Management Code TMP1 on liquidity risk management says: ‘This organisation will not borrow earlier than required to meet cashflow needs unless there is a clear business case for doing so, and will only do so for the current capital programme, to finance future debt maturities, or to ensure an adequate level of investments to provide liquidity for the organisation’. This may be a prudent activity in order to secure borrowing against the risk of future unavailability or the risk of future interest rate rises. Such activity is only likely to be prudent in relation to borrowing needs in the short to medium term, say up to three years ahead, given the uncertainty of future needs and circumstances.

Investments for service purposes

4 Service investments are, by definition, primarily part of service delivery rather than income generation or treasury management. However, the Code's requirements include service investments because they are still investments, with investment risk characteristics. Service managers are not always familiar with investment risks and how to manage them. Service investments (and investment income) can sometimes be very material for an authority (eg airports and energy companies). Authorities must also account for capital investments differently from non-capital investments, calculate annual impairments and report fair value. For all these reasons, finance teams and treasury management officers should have an involvement in the management and monitoring of service investments.

5 Service investments must be directly involved in the delivery of a service to be classified as service investments. For example, loans to leisure providers, loans to trusts providing services, a shareholding in a shared service vehicle, and investments in local companies for regeneration. An investment whose only connection to services is to produce income to support service finances, is an investment for commercial purposes and not for service purposes.

Investments for commercial purposes

6 'Commercial' in this context refers to the purpose of the investment, not its nature. Investments for commercial purposes are undertaken as a commercial business activity seeking profit. Treasury management investments will be made on fully commercial terms, but they result from the organisation's cashflows or treasury risk management activity; service investments may not always have fully commercial terms, and may involve some element of subsidy in order to support service objectives (service loans of this nature would probably be accounted for as 'soft' loans).

7 What distinguishes commercial investments from treasury management investments is the purpose of, and need for, the investment. The Code defines commercial investments as 'investments taken or held primarily for financial return and not linked to treasury management activity'. 'Primarily for financial return' means that the main reason why the investment was entered into – or is now being held – is to earn money. 'Primarily' means 'for the most part; mainly', so that if the investment objectives were weighted, the weighting to financial return would have to be over 50% for it to be the primary purpose. The examples in the PWLB guidance for loan applications from 26 November 2020 may be useful to help decide this in relation to regeneration projects and preventative action. Officers should consider professionally and realistically whether an investment really is primarily for regeneration or other services, or primarily for financial return. They should document their reasoning for determining whether an investment is primarily for financial return.

8 'Financial return' covers all investment returns, both income and capital gains.

9 Treasury management investments arise from a cashflow surplus. The cash will in due course be needed to meet the service delivery needs of the authority, and that determines how long the cash should be invested for. Investments which are of a longer term nature than warranted by the expected cash surplus are therefore unlikely

to be made for treasury management purposes: the only reason for holding such long term investments would be to make a turn above the cost of borrowing.

10 Accordingly, an investment which is of a long term nature (eg equities, commercial properties, long term bonds, or pooled funds of these investments) is likely to be a ‘commercial investment’ if made by an authority which is a net borrower, because an authority which has a cash need to borrow is unlikely to have surplus cash for long enough to justify such long term investments.

11 When making investments, authorities should (like any investor) ask themselves where the money has come from and how long it is available for investment before it may need to be used. That then determines the appropriate type of investment. If the authority expects to need to borrow in a year’s time, it should not be investing in asset classes appropriate for only longer term investment.

12 The liability benchmark should identify whether an authority is borrowing and investing more than it needs for treasury cashflow management purposes. For net borrowing authorities, the liability benchmark identifies the authority’s future need for borrowing, including a reasonable allowance for liquidity investments to meet uncertain cashflows. A level of investments which exceeds the reasonable cashflow and liquidity needs of the authority, indicates excess investments which are not required to safely look after temporarily surplus cash, but which may have been taken primarily for financial return. The authority is borrowing more than it needs to in order to hold these investments.

13 Debt-free authorities do not have a ‘liability’ benchmark, but can identify an equivalent ‘asset’ benchmark which shows the forecast volume and lifetime of the surplus cash available for investment. Investments of a longer term nature than required to cover cashflow surpluses may therefore have been taken primarily for financial return, rather than to safely look after the cash whilst it is surplus. Debt-free authorities may have surplus cash for an extended number of years. The appropriate diversified investment of these long term surplus funds may therefore include some equities or property. These would be investments for treasury management purposes, and not investments for commercial purposes.