CIPFA Statement on why Authorities should not borrow to invest

Extract from Prudential Code Guidance

BORROWING TO INVEST – CIPFA Guidance (Appendix 3 of 2021 Local Authority Treasury Guidance).

(Prudential Code Guidance paragraph 169)

Why shouldn't authorities borrow to invest?

1 Investing in commercial investments, 'primarily for financial return', should be treated with great caution by local authorities. Firstly, commercial investments are generally in higher risk asset classes. This is likely to mean uncertain and volatile asset prices or income. Commercial property is also relatively illiquid compared with most financial investments, and is likely to take several months at least to realise. An urgent sale, if the authority's circumstances or if market conditions change, may not produce the best price. Such investments require expert due diligence before purchase, and careful asset monitoring and management afterwards. Local authorities do not always have these skills, and should not rely on external advice unless they understand the product and the risks themselves. If the investment goes wrong, the cost falls on public services or the local taxpayer.

2 Secondly, if authorities borrow to invest primarily for financial return, this constitutes 100% debt leverage. The intention is to earn a margin between borrowing costs and investment income, in the expectation that the income will be higher than the costs. However, the margin earned is not free money, but prices in the market's assessment of the additional risks involved. The higher the margin, the more at risk the investment is likely to be. If the investment underperforms, it may result in revenue account losses to the authority, or a capital loss on redemption.

3 Leveraged investment considerably magnifies these risks, because it also brings borrowing risks such as interest rate risk and refinancing risk. The authority has a fixed debt repayment liability on one side of the balance sheet, but an uncertain asset value on the other side of the balance sheet. This can be expressed in terms of market values: if markets move the wrong way for the authority, the fair value of the borrowing liability may become significantly higher whilst the fair value of the investments may fall. The authority would be at a loss in its leveraged investment activity.

4 Commercial investments (including commercial property) are not part of cashflow management or prudent treasury risk management, and they do not directly help deliver service outcomes. Leveraged investment is a form of speculation, which chooses to take on additional risk in order to earn a profit, much as an investment bank or property company might do. A local authority has powers to borrow and invest 'for the prudent management of its financial affairs' (Local Government Act 2003 sections 1 and 12). It is CIPFA's view that throughout the public services the priority for treasury management is to protect capital rather than to maximise return. The magnified risks of leveraged investments, and the fact that they put public money at unnecessary risk, mean that borrowing in order to invest for the primary purpose of earning a return is not in CIPFA's view a prudent use of public funds.

Is the authority borrowing for the investment?

1 The Code says that authorities must not borrow to invest for the primary purpose of financial return, but it is not always straightforward to identify if the authority is borrowing for this purpose or not. Any authority which is a net borrower and which is holding or considering investments of a long term nature must consider whether it is in effect borrowing to invest.

2 When authorities are considering if they are borrowing in order to invest, they need to look at the substance rather than the form. A net borrowing authority may not need to borrow on the day it invests in a property fund, but if it will need to borrow significantly at some point within the expected life of the investments, then it is (or will be) in effect borrowing to invest.

3 The local government finance system does not generally allocate individual loans to particular expenditure. Authorities should not attribute prudential borrowing to other capital expenditure, in order to appear not to be borrowing to finance investments. Can the authority genuinely argue that its commercial property investment plans are being financed from capital grants or capital receipts? If the commercial investments were taken out of the capital programme, what would reduce – the use of grants and receipts or the use of prudential borrowing? An authority which is financing any part of its capital programme by prudential borrowing, and whose CFR is increasing, is likely to need to borrow in cash terms at some point.

Existing commercial investment portfolios

4 The Code's statement that authorities 'must not borrow to invest for the primary purpose of financial return' is not intended to require the forced sale of existing commercial investments, whether commercial properties or financial investments. Selling these investments and using the proceeds to net down debt does, however, reduce treasury risks on both sides of the balance sheet and is therefore an option which should be kept under review, especially if new long term borrowing is being considered.

5 Borrowing for commercial property should be subject to annual MRP, and so the debt will over time be repaid. However, borrowing for financial investments of a commercial nature is unlikely to be subject to MRP (the acquisition not being capital expenditure), and there is therefore no debt repayment requirement. The Code therefore requires in para 53 that authorities which are net borrowers should review options for exiting their financial investments for commercial purposes in their annual treasury management or investment strategies. The options should include use of the sale proceeds to repay debt or reduce new borrowing requirements. They should not take new borrowing if financial investments for commercial purposes can reasonably be realised, based on a financial appraisal which takes account of financial implications and risk reduction benefits. This enables authorities to weigh the risk reduction benefits of sale against the loss of income and the current sale value of the investments; but it is expected that authorities will look hard at progressively selling these investments over time.

6 Code paragraph 53 also makes it clear that where an authority has existing commercial properties, the Code's requirement that an authority must not borrow to invest for the primary purpose of financial return, is not intended to prevent authorities from appropriate capital repair, renewal or updating of existing properties.

PROPORTIONALITY OF COMMERCIAL INVESTMENTS

(Prudential Code Guidance paragraph 15)

5 An objective of the Prudential Code is that the risks associated with commercial investments are proportionate to their financial capacity – ie that plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services (Prudential Code

para 1(f)). In particular, could the authority's budget survive a major reduction in its income from investments (in total) if some perform badly or fail? The Code does not prescribe a defined proportion, and proportionality is expressed broadly in relation to the key components of an authority's financial capacity: the ability for any losses to be absorbed in existing budgets or useable revenue reserves. This is a matter for each authority to judge with the guidance of its Chief Financial Officer. CIPFA's publication *Prudential Property Investment* (2019) further considers issues of risk and proportionality in commercial property investment.

6 This is closely related to the authority's risk appetite, and the two can be considered together: how much downside risk from commercial activities, or from treasury management, can the authority manage within its revenue budgets and reserves?