Report Number: SWT 140/22

Somerset West and Taunton Council

Audit and Governance Committee – 7 November 2022

External Auditor’s 2020/21 Key Recommendation Update

This matter is the responsibility of Executive Councillor Benet Allen, Portfolio Holder for Corporate Resources

Report Author: Paul Fitzgerald, Assistant Director – Finance and S151 Officer

1 Executive Summary / Purpose of the Report

1.1 The external auditor included a Key Recommendation within his Auditor’s Annual Report for 2020/21 presented to the Audit and Governance Committee on 13 December 2021. This referred to the auditor’s risk assessment related to the Council’s level of investment under its Commercial Property Investment Strategy, which is one of the fundamental pillars of the Council’s agreed financial strategy.

1.2 An extensive management response to the recommendation was included in the report at the time and this report provides the Committee with an update on further progress since that time in reducing risks in this area.

2 Recommendations

2.1 The Committee is recommended to consider and note the arrangements in place to mitigate risks and the further actions taken in response to the auditor’s Key Recommendation.

3 Risk Assessment

3.1 This report relates to the management of risk in respect of the Council’s property investment strategy. The risk assessment is covered in detail in the main body of the report.

3.2 Management is satisfied that risks are being effectively managed in this regard.

4 Background and Full details of the Report

4.1 The Council first agreed its commercial property investment strategy in December 2019, as one of the pillars of its overall financial strategy. This was agreed with the purpose of investing in property assets for rental income to fund local services and help mitigate the significant reduction in other core funding from central government. The strategy has been reviewed annually, with 6-monthly progress reports provided to Full Council.

4.2 The Council agreed to invest up to £100m in income-generating assets with an initial net income target of £2m per annum. This income target was subsequently revised to £2.9m in 2020.

4.3 The first acquisition for the Fund was completed in August 2020 with the final purchase completed in December 2021. Twelve properties in total are included in the Fund, as detailed in previous reports. In total £99m has been invested over the two financial years. The assets are included on the Council's Balance Sheet at current value, with the income, management costs and financing costs built into the General Fund annual budget.

4.4 The Council's Leadership team agreed to include assurance reviews within our Internal Audit annual plans in both 2020 and 2021. The first review provided an early focus on the governance arrangements that have been established to implement the strategy, and the second review sought to ensure decisions are being made in line with the approved strategy. The **Internal Auditor provided a Substantial Assurance opinion in both reports**:

Report	Assurance	Recommendations for Action
Commercial Investments Governance (July 2020)	Substantial	0
Commercial Investments (August 2021)	Substantial	2 (both Priority 3 and completed)

4.5 As part of the annual audit process our external auditor, Grant Thornton LLP, provides an Auditor's Annual Report (AAR) with commentary on the Council's arrangements for securing economy, efficiency, and effectiveness in its use of resources. This includes themes of:

- Financial sustainability
- Governance
- Improving economy, efficiency, and effectiveness

4.6 Grant Thornton's AAR for 2020/21 was presented to Audit and Governance Committee on 13 December 2021. Within the report, the auditor included in his risk assessment "A significant weakness has been identified relating to the Commercial Strategy". The auditor therefore included a Key Recommendation as follows:

Key Recommendation: "The Council should develop a clear plan to address and mitigate the risks that it is exposed to as a result of the Commercial Property Investment Strategy."

4.7 The report includes a summary of the auditor's findings:

"The Council is acquiring a £100m commercial property portfolio over two years which is funded from borrowing, with £44m invested in 2020/21. From our review of the Council's Commercial Property Investment Strategy we consider that it is a departure from the principles of prudent activity that will be reinforced in the revised CIPFA Prudential Code. We have concerns around the scale of the commercial investment and the risks that it exposes the Council to. The General Fund will be dependent upon £7.1m commercial investment income by 2023/24. Regardless of the performance of the investment portfolio, the General Fund will have to pay MRP costs associated with the commercial acquisitions, which is forecast as £2.0m for 2023/24. HM Treasury and CIPFA have continued to comment on commercial investment activity and its (sic) prudence, with access to PWLB borrowing to finance investment activity of this nature stopped from November 2020 with a view to curtail this activity by Local Authorities."

4.8 The Council's S151 Officer interprets this recommendation as reflecting the auditor's recognition of the risks associated with increasing the Council's borrowing requirement by this amount and the reliance upon future investment income to fund services. It is not in his view a concern about the quality of the Council's governance arrangements and approach per se but of the scale of investment undertaken.

4.9 The Council's initial management response was included within the AAR in December 2021 and is set out in full in the Appendix to this report.

4.10 Summary of risk mitigations already in place:

- A clear approved Strategy which includes arrangements to assess and manage risk, with investment criteria reflecting appetite for risk.
- Diversification of income streams within the Financial Strategy.
- Governance arrangements designed to enable effective delivery of the Strategy.
- Prudent budget estimates for investment income.
- Appropriate use of skills, knowledge, and experience within our teams and procurement of professional services to support implementation.
- Robust due diligence to support investment decisions.
- Creation of a balanced portfolio for the Fund.
- A prudent approach to treasury management taking into account advice from our expert advisors.
- A borrowing approach that enables flexibility in view of local government reorganisation, including a blend of internal borrowing and external loans.
- A prudent approach to debt repayment with Minimum Revenue Provision included within the budget and medium term financial plan.
- Holding adequate reserves to mitigate income volatility and potential asset management costs.
- No plans to increase scale of investment above that agreed in the original approved Strategy.

4.11 As shown above the Council already applies a wide range of measures to manage and minimise risk for this activity. However, the Council has employed further steps to reduce risk following the identification of the Auditor's concern when the AAR was published in December 2021. These include:

- Using revenue funds towards financing of investment asset purchases, reducing the overall need to borrow.
- Accelerating debt repayment through additional MRP charges, reducing the quantum of borrowing needed and reducing refinancing risk as well as reducing future MRP and interest cost exposures.
- Increasing the balance of funds held in the Investment Risk Reserve and Investment Assets Sinking Fund, increasing resilience if actual results are adverse compared to budget.

Financing Using Revenue Funds and Additional Debt Repayments

4.12 The Strategy was originally prepared based on financing the capital costs of asset acquisitions through borrowing. However, the Council has agreed to part-fund these costs through use of revenue funds, i.e. cash rather than debt, with a total of £3.5m of capital costs financed in this way. This means the total borrowing requirement is reduced by 3.6%.

	£000	%
Investment property purchases funded through borrowing	95,445	96.4%
Revenue Contribution to Capital Outlay (RCCO)	3,520	3.6%
Total Capital Costs of Investment Properties	98,965	

4.13 The Council has an established policy for capital debt repayment – the Minimum Revenue Provision (MRP) policy. Prudently the policy provides for full debt repayment for the upfront borrowing requirement at 2% annually. Whilst not hardwired into the Policy with specific dependencies, and therefore not relied upon for prudent management, there is also the option highlighted within the treasury strategy to consider over the long term further reductions of borrowing where capital growth is realised.

4.14 MRP costs have been budgeted within the MTFP at £2m per year in respect of the investment property fund. Total MRP calculated per standard policy over the two years 2021/22 and 2022/23 totals £2.77m (no MRP due in 2020/21). To reduce financing risks, MRP overpayments – or accelerated debt repayments – totalling £1.112m have also been applied over the two years.

	£000
Investment property purchases funded through borrowing	95,445
Scheduled MRP per standard policy 2021/22 + 2022/23	-2,770
MRP Overpayments 2021/22 + 2022/23	-1,112
Residual Borrowing Requirement as at March 2023	91,563
Note: Residual Debt as % of Total Capital Expenditure	92.5%

4.15 Together the MRP overpayments and RCCO funding has reduced the borrowing requirement by an additional **£4.632m (4.7%)** thus reducing risks and costs quicker than the original strategy. Residual debt at March 2023 is £91.563m. By comparison, the residual debt at March 2023 would be £96.195m without these additional measures.

4.16 These measures mean that calculated MRP for 2023/24 is estimated to be £1.886m. This provides the option to reduce the MRP budget by £114k and provide a budget saving, or to further overpay MRP by up to this amount if the MRP budget is maintained at £2m for these properties.

Increasing Risk Reserves Balances

4.17 The risk management plan includes holding adequate reserves to mitigate net investment income volatility adversely affecting the outturn against budget. Through prudent financial planning an Investment Risk Reserve has been front-loaded with a £3m balance for this purpose, with a further £0.5m set aside in an Investment Assets Sinking Fund to be available to finance unavoidable landlord costs.

4.18 We have so far not needed to dip into these reserves. By contrast, we have added £151k to the Risk Reserve in 2021/22 from surplus investment income.

4.19 Through the 2022/23 Quarter 1 financial monitoring report the S151 Officer has recommended that a further £1m is added to the Investment Risk Reserve and a further £0.2m is added to the Sinking Fund, reallocating funds from other earmarked reserves where risk has reduced. This further strengthens the Council's resilience to ongoing volatility risk, with a total of £4.8m held in reserve to support the Commercial Property Investment Strategy.

4.20 It is also worth noting that, as well as these specific risk reserves, the Council currently holds a General Reserves balance of £6m+ as well as other earmarked reserves, providing wider financial resilience to support the General Fund.

Treasury Management

4.21 With the acquisition of its Commercial Property portfolio, the Council has needed to undertake additional external borrowing. Internal borrowing has supported the new acquisitions whereby cashflow balances have been utilised as far as possible to reduce the immediate impact of costs and risks associated with new borrowing. Examples of the main costs and risks might include:

- 'the cost of carry' – a term that relates to the short-term extra cost of borrowing over and above the interest received on holding the resulting additional cashflow at a lower interest rate.
- The risk posed by investments placed with any financial institution or entity that may suffer insolvency on the basis that, arguably, no entity is regarded as being immune to insolvency.

4.22 During 2021/22, in particular, our overall cashflow balances reduced, and we embarked on a programme of obtaining new external borrowing. The approach taken was influenced by a range of factors:

- Potentially, the forthcoming local government review may develop a revised policy towards property investments.
- The consolidation of cashflow balances and reserves held by the five existing Somerset councils upon unification may potentially be sufficient to avoid the need for borrowing needed for the property investments after 1 April 2023.
- Development of a new treasury management strategy for 2023/24 and beyond may re-shape the approach to borrowing in the longer-term.
- Exceptional developments and uncertainties in global and domestic (UK) economies, which required close monitoring whilst planning the new borrowing activities.
- The Treasury Team's view, based on economic data and market reaction, that there would be a growing risk of rises in UK money market interest rates, in the shorter-term at least.
- Bank of England announcements regarding its intentions for controlling inflation by using monetary policy measures, particularly interest rates.

4.23 The combination of all the above factors led to a carefully timed and balanced approach to sourcing new external borrowing. However, whilst councils have historically enjoyed the benefits of borrowing from the Government through the Public Work Loans Board (PWLB), access to new PWLB borrowing was eventually removed from this and other councils. This followed HM Treasury's concerns regarding councils' growing commercial investment activity being financed by Government loans. As a result, in November 2020, this council's (and others with property investments) option for new PWLB borrowing ceased, although refinancing of non-investment related borrowing is permitted.

4.24 This did not eliminate other options for borrowing through the Money Market. Whilst a range of alternative options for financing remain available, many councils carry surplus balances that are, in turn, available for other councils to borrow. This presented us with a reliable source of borrowing and at affordable rates of interest, which we were successful in translating into a well-balanced series of short-term loans (below one year) and a modest level of medium-term loans (up to four years in practice). We succeeded each time in securing fixed rates of interest ahead of the subsequent increases in market interest rates.

4.25 Most of the borrowing was fixed for repayment on a narrow spread of dates close to vesting day when the new Unitary Council commences. The spread of dates removed one substantial impact on cashflow management and financing around 1 April 2023, which is expected to be a challenging time for the new Council's financial operations. The medium-term borrowing was taken, firstly, to reflect that we require borrowing for other purposes such as the financing of the HRA capital programme and, secondly, provided a wider spread of financing periods, as recommended by our Treasury Advisors, Arlingclose. We succeeded in obtaining favourable fixed interest rates on the medium-term borrowing too, which has already been substantiated by market indications for a prolonged period of higher interest rates. The main outcome from the medium-term component of borrowing, even though being a smaller proportion of the overall spread, has been the protection against potential for higher costs of refinancing debt, the certainty and affordability provided, and the protection gained from the fixed interest rates achieved.

4.26 Regarding the Council's overall borrowing needs, it is also relevant to note that as part of the 2021/22 financial outturn we have reduced the need for borrowing within the Council's General Fund Capital Programme by £35m. As a result, the approved prudential borrowing limit set by the Council reduces by this amount, which reduces total risk in terms of prospective total exposure to borrowing.

4.27 The 2022/23 total General Fund Budget reflects total income of £77m from a variety of sources including sales, fees and charges, rental income, grants and contributions, benefits subsidy, treasury investments, investment properties, business rates, council tax and core funding grants from central government. Gross income from investment properties provides approximately 9% of total income used to fund services and service the debt related to investment properties.

5 Links to Corporate Strategy

5.1 The Commercial Property Investment Strategy forms a pillar of the Council's Financial Strategy, seeking to provide resources necessary to meet the Council's service priorities and mitigate significant reductions currently foreseen in other sources of funding over several years.

6 Finance / Resource Implications

6.1 The Council has invested a total of £99m in the Property Investment Portfolio during 2020/21 and 2021/22, which is estimated to deliver a gross income of £6.9m and a net income of £4m after management and financing costs in 2022/23.

6.2 Net income is budgeted to reduce to £3.3m in 2023/24 from the current portfolio because of prudent assumptions around increased borrowing costs through rising interest rates. This budget estimate still compares favourably with the net income target of £2.9m as targeted by the Commercial Property investment Strategy, providing flexibility to consider further transfers to reserves if required.

6.3 The upfront investment has been financed through £3.5m of revenue funds and £95.5m borrowing. Borrowing is undertaken through our treasury management team and to date the financing has been delivered through a combination of internal borrowing and external loans. Details of the Council's overall borrowing position is included in Treasury Management Reports to the Audit and Governance Committee.

6.4 As set out in section 4 above, the Council has so far provided funds for debt repayment through the Minimum Revenue Provision (MRP) charged to the revenue account totalling £3.9m. This includes £1.1m of accelerated 'overpayments' of MRP to more quickly reduce the borrowing requirement.

6.5 The total borrowing requirement related to this investment strategy is now £91.56m which represents 92.5% of the original investment cost. The Council's financial plan includes provisions for further debt repayment of c£2m annually, which will continue to reduce the borrowing requirement over time, reducing refinancing risk.

6.6 The Council currently holds £4.1m in an earmarked Investment Risk Reserve to mitigate potential adverse variances to budget if income should fall below expectation. This provides a significant level of resilience, for example 1% volatility in gross income for the year would be £69k; 5% volatility would be £345k; 10% volatility would be £690k.

6.7 The Council also currently holds £0.7m in an Investment Assets Sinking Fund earmarked reserve providing additional funding for asset maintenance costs if required.

Unitary Council Financial Implications and S24 Direction Implications

6.8 The investment property assets held, and associated balance of the capital financing requirement, will transfer to the new unitary Somerset Council on 1 April 2023. The only relevant S24 implications relate to any potential refinancing with long term loans greater than £5m which will need specific consent from the SCC S151 Officer. Specific consent would also be required if additional investment assets purchases were planned, but no such activity is planned this year.

6.9 A requirement of the updated Prudential Code is that at least annually the Council will consider its strategy for investments for yield and will consider whether investment exposure should be reduced to reduce risk.

7 Conclusion

7.1 The Council has a clear strategy supported by robust governance and operational arrangements in place to manage its current investment property portfolio and associated risks. This has been independently reviewed with substantial assurance provided by our internal auditor. The finance team has taken reasonable steps to implement effective treasury management arrangements that manage risks of investment and borrowing for the Council. Despite the limitations to PWLB access, the Council has secured the borrowing required in advance of the transfer to the new unitary council.

7.2 Through the LGR Finance Workstream, work is underway to assess the overall capital financing requirements of the new Council for 2023/24 onwards with the five Councils' investments and loans transferring on 1 April 2023. It has been agreed by all the S151 Officers through the Finance Workstream Board that it is sensible to consider longer term treasury management decisions once this assessment has been completed. This position is also supported by advice from Arlingclose to this effect. Therefore, the plan to address longer term financing of investment will be managed through the LGR process.

7.3 The Council has acted positively to respond to the Auditor's recommendation by reducing the overall borrowing requirement and strengthening its investment risk reserves, whilst maintaining prudent budget estimates. The **borrowing requirement has been reduced ahead of strategy by some £4.63m** through accelerated debt repayment and use of revenue resources instead of borrowing. In addition, **risk and asset management reserves have been increased by £1.2m to increase resilience**.

7.4 The high-level plan to manage risk ongoing can be summarised as follows, but with added elements as explained within this report in more detail:

- Maintaining robust governance and operational management of the portfolio with regular reviews to be undertaken in line with Prudential Code guidance.
- Managing investment spread on an ongoing basis to keep risks in balance.
- Realistic budgeting for net income from investments.
- Maintaining adequate reserves to mitigate income volatility risk and ongoing asset management requirements.
- Continue to operate a prudent MRP policy that reduces the capital financing requirement over time; and taking opportunities to accelerate debt repayment from income surpluses and capital gains from time to time.
- Managing future borrowing arrangements through a holistic treasury management strategy, using internal borrowing to maintain reduced treasury risk, and securing external borrowing on most appropriate beneficial terms when required.

Democratic Path:

- **Audit and Governance Committee – Yes (27/09/2022)**
- **Executive – No**
- **Full Council – No**

Reporting Frequency: Once only

Contact Officers

Name	Paul Fitzgerald
Direct Dial	01823 217557
Email	S151@somersetwestandtaunton.gov.uk
Name	John Dyson
Direct Dial	
Email	S151@somersetwestandtaunton.gov.uk

Management Response to Key Recommendation within the Auditor's Annual Report December 2021

The Council has been very robust in its identification and management of risk regarding the commercial strategy and related financing approach. This is clearly set out in the Commercial Strategy, Financial Strategy and Capital, Investment and Treasury Strategies. The Council has been open and transparent in its regard to the Prudential Code and the reasons for pursuing commercial investment as a means of diversifying its income streams to mitigate significant reductions in government funding and to support investment in local council services. We have complied with reporting requirements in respect of the Prudential Code and Capital Investment statutory guidance, and carefully considered aspects such as proportionality. The treasury approach to borrowing has been considered in view of advice from our treasury management advisors, medium term forecasts in respect of interest rates and volatility, the nature of investment and also with consideration to local government restructuring expected in April 2023.

Securing long term borrowing: In view of the nature of the portfolio, preserving flexibility to scale down the portfolio and/or debt level, and balancing costs and risks, it is regarded as prudent to avoid 'locking in' to long term debt at this point. The refinancing risk is carefully monitored and is currently considered low. The Council's overall debt portfolio contains a blend of long term and short term borrowing. It is proposed to review total financing structures as part of the transition to the new unitary and taking into account its future policy in respect of commercial investment.

Managing impact on the General Fund and Prudent Debt Repayments: Robust arrangements are already in place to manage risk to the General Fund. This includes: realistic budgeting for income and costs including: an optimism bias adjustment, budgeted annual MRP charges to the revenue account to reduce debt, a significant up-front Investment Risk and Volatility reserve balance of £3.7m with a strategy to increase year on year, Investment Financing Reserve of £2m; underpinned by strong governance and thorough due diligence to minimise risk. The MRP policy includes prudent provision for debt repayment annually which is reflected in the budget and MTFP. It is anticipated that in the longer term there will also be options to trade the portfolio and realise capital growth to further reduce debt.

Shadow Council risk awareness: Commercial Investment is included within the Finance Workstream as part of the LGR Implementation Programme, which will be the platform to enable the Shadow / Transition Council's appointed S151 Officer (when appointed) to inform and advise the successor authority.

Full compliance with the revised Prudential Code: It is proposed to consider this through the transition to unitary and taking into account the new Prudential Code when published (expected late December 2021). There is no plan for SWTC to increase investment beyond the existing approved level which is expected to be completed by December 2021. Our understanding is that CIPFA does not intend local authorities to rapidly dispose of existing commercial properties and create a 'cliff edge' in councils' income, but will require a halt to further capital investment purely for yield and a measured consideration of future opportunities for disposal of investment properties to reduce risk. It is anticipated this and will require the unitary Council's financial strategy to consider risk and future options to mitigate the significant reduction in net income this investment currently provides if asset investment is reduced.

As a general point, a comprehensive coverage of anticipated changes to the Codes and related risks is included in the mid-year Treasury Management report to the Audit and Governance Committee 13 December 2021, ensuring transparency and public accountability.