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12 March 2004

Dear Colleague

**LOCAL GOVERNMENT INVESTMENTS
GUIDANCE UNDER SECTION 15(1)(a) OF THE LOCAL GOVERNMENT ACT 2003**

With my letter of 15 December 2003, I circulated for consultation draft guidance on local government investments. The consultation ended on 30 January and we are most grateful to all the authorities and other bodies who responded. We have considered the comments in liaison with the Local Government Association, the Audit Commission and CIPFA.

The guidance is now formally issued by the Secretary of State under section 15(1)(a) of the *Local Government Act 2003*. I enclose a copy of the guidance, together with an informal commentary and background information.

The guidance applies in relation to the financial year 2004-05 and subsequent financial years. However, authorities are required to have regard to it immediately, since action is needed now. Normally, an Annual Investment Strategy should be approved by the full Council before the start of the financial year (paragraph 11 of the guidance). If it is impracticable for the Council to meet before 1 April this year, approval may, on this occasion only, be obtained as soon as possible after the start of the financial year.

Authorities who have prepared their Strategies on the basis of the draft guidance are unlikely to need to revise them, since the content has not changed substantially. The main outcome of the consultation is outlined in paragraph 9 of the commentary, which explains that regulations have been made to ensure that certain investments (in *money market funds* and *multilateral development banks*) will not count as capital expenditure.

The present investments rules, in the *Local Authorities (Capital Finance) (Approved Investments) Regulations 1990*, made under Part 4 of the *Local Government and Housing Act 1989*, will of course cease to have effect when Part 4 is repealed on 1 April 2004.

Any enquiries about the guidance should be addressed to my colleague Ross Buchanan here at: ross.buchanan@odpm.gsi.gov.uk

Yours sincerely

Trevor Emmott

GUIDANCE ON LOCAL GOVERNMENT INVESTMENTS

Office of the Deputy Prime Minister

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Part 1 of this document gives informal advice only and is not part of the guidance itself, which is contained in Part 2.

PART 1 - BACKGROUND AND COMMENTARY

(1) INVESTMENT POLICY

1. Since 1990, local government investments have been subject to the *Local Authorities (Capital Finance) (Approved Investments) Regulations 1990* [SI 1990/426 as amended], made under Part 4 of the *Local Government and Housing Act 1989* ("the 1989 Act").

2. The repeal of Part 4 on 1 April 2004 by the *Local Government Act 2003* ("the 2003 Act") and the parallel revocation of the "approved investments" regulations brings this regime to an end, as part of the introduction of the new prudential capital finance system. Under the new system, the Government still wishes to encourage authorities to invest prudently, but without burdening authorities with the detailed prescriptive regulation characteristic of the 1989 Act system. The issue of guidance under section 15 of the 2003 Act implements that policy.

(2) INVESTMENT POWER

3. **Section 12** of the 2003 Act removes the doubts which persisted under the 1989 Act regime and gives a local authority power to invest for "any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs". The reference to the "prudent management of its financial affairs" is included to cover investments which are not directly linked to identifiable statutory functions but are simply made in the course of treasury management. This would also allow the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future; however, the speculative procedure of borrowing purely in order to invest remains unlawful.

(3) INVESTMENT GUIDANCE BY CIPFA

4. **Section 15(1)** of the 2003 Act requires an authority "...to have regard (a) to such guidance as the Secretary of State may issue, and (b) to such other guidance as the Secretary of State may by regulations specify...".

5. The *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* [SI 3146] (made under the *Local Government Act 2003*) contain a regulation [regulation 24] relying on the power in section 15(1)(b). It requires authorities to have regard to the

Chartered Institute of Public Finance and Accountancy (CIPFA) publication ***Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes***. This Code covers the whole range of treasury management issues, including the fundamental principles for making and managing investments. It should be noted that the Code prepared by CIPFA for the new capital finance system, ***The Prudential Code for Capital Finance in Local Authorities***, also includes guidance on treasury management.

6. The guidance in Part 2 of this document is issued under the power in section 15(1)(a). This does not duplicate the material covered in the CIPFA Codes but builds upon it and supplements it as necessary to implement the Government's policy. A detailed commentary on the guidance is given below (paragraphs 12 to 25).

(4) INVESTMENT REGULATIONS

7. The *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003*, which come into force on 1 April 2004, include provisions relevant to investments.

8. Regulation 25(1)(d), made under section 16(2) of the 2003 Act, defines as capital expenditure the acquisition of **share capital or loan capital** in any body corporate. This continues the effect of the provision in section 40(4)(b) of the 1989 Act. Such investments will therefore need to be funded out of capital or revenue resources (as well as being subject to the guidance on "non-specified investments"). The intention here is to discourage the use of speculative investments, such as equities.

9. In the consultation on this guidance, representations were made to ODPM that the definition in regulation 25(1)(d) would apply to investments in *money market funds* (as defined in regulation 1 of the *Approved Investments Regulations 1990*). Accordingly, amendments have now been made in the *Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2004 [SI No. 534]*, which also come into force on 1 April 2004, to exclude such investments from the definition of capital expenditure. Similar concern was expressed in relation to bonds issued by the kinds of bodies listed in Part 1 of the Schedule to the 1990 regulations. Again, this is dealt with in the amending regulations, which exclude from the definition of capital expenditure investments with a *multilateral development bank* (defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world). These amendments to regulation 25(1)(d) are relevant to the interpretation of paragraph 12(c) in the guidance. The effect is that investments in money market funds or with multilateral development banks are *not* capital expenditure and may be "specified investments" (subject to the other conditions in paragraph 12 of the guidance also being met).

10. Investments not defined as capital expenditure by regulation 25(1)(d) will not score as expenditure at all and will not be charged to revenue or capital. However, if any existing investment ever appeared at risk of loss, normal accounting practice would as now require the authority at that time to make revenue provision of an appropriate amount.

11. It should also be noted that regulation 25(1)(b) defines as capital expenditure a **loan** (or grant or other financial assistance) by an authority to another body for capital expenditure by that body.

(5) INFORMAL COMMENTARY ON THE ODPM GUIDANCE

12. Under the power in section 15(1)(a) in the 2003 Act, the Secretary of State has issued the guidance on investments in Part 2 of this document. Local authorities are required by section 15 of the 2003 Act to have regard to this guidance. It may also apply to parishes (see paragraph 25). The guidance applies only in England.

13. The guidance does not apply to pension and trust funds which are covered by a completely separate regulatory regime.

14. The general policy objective is that local authorities should invest **prudently** the surplus funds held on behalf of their communities.

15. The guidance recommends that priority should be given to security and liquidity. However, that does not mean that authorities should ignore yield. It will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity.

Annual Investment Strategy

16. The Annual Investment Strategy is central to the guidance. As noted above, authorities will also need to have regard to the CIPFA Treasury Management Code, which requires the preparation of an annual treasury management strategy and plan in advance of the year and an annual report after the year end. There is no intention to require authorities to duplicate any of the tasks specified in the CIPFA Code. It may be convenient to produce a single strategy document, covering both the requirements of the CIPFA code and the Secretary of State's guidance. However, the document should state explicitly where it is dealing with the guidance by the Secretary of State.

17. The Secretary of State recommends (paragraphs 7 to 9 of the guidance) that the Strategy should be approved by the full Council (or at equivalent level in authorities without a Council). The *Local Authorities (Functions and Responsibilities) (England) Regulations 2000 (S.I. 2000/2853, as amended)* empower a Council to determine that it should be responsible for such matters as approving the Strategy and that is what the guidance recommends. It is intended that an amendment will shortly be made to the regulations specifying that the function of approving such strategies is always for the full Council.

18. Normally, the Strategy should be approved before the start of the financial year. Because this guidance is being issued shortly before the start of 2004/05, it may not be feasible to have the Strategy for that year endorsed by the Council before 1 April 2004. In that case, approval should be obtained as soon as possible after that date.

19. The Strategy may be varied at any time during the year, again with the approval of the full Council. It should be possible to incorporate in the Strategy sufficient flexibilities and delegations to avoid the need for a formal variation, other than in the most exceptional circumstances. Where external investment managers are used, they should be contractually required to comply with the Strategy.

Specified Investments

20. The idea of specified investments is to identify investments offering high security and high liquidity. Authorities will be free to rely on these with minimal procedural formalities. All such investments should be in sterling and with a maturity of no more than a year. Such short-term investments made with the UK Government or a local authority or parish council will automatically count as specified investments.

21. In addition, short-term sterling investments with bodies or investment schemes with "high credit ratings" will count as specified investments. However, the Annual Investment Strategy should define this term for broad categories of investment. The Strategy should also say how frequently ratings are to be monitored and what is to happen if they change.

Non-specified Investments

22. The Annual Investment Strategy should deal in more detail with non-specified investments, given the greater potential risk. It should identify the types of investments that may be used during the course of the year and should set a limit to the amounts that may be held in such investments at any time in the year. The limit may be a sum of money or a percentage of total investments. The Strategy should also lay down guidelines for making decisions on such investments, for example, on the circumstances in which professional advice is to be sought.

23. There is no intention of discouraging authorities from using non-specified investments. The aim is simply to ensure that proper procedures are in place for undertaking risk assessments of investments made for longer periods or with bodies which are not highly credit-rated. It is not implied that credit ratings are the only means of assessing creditworthiness; but where an alternative or additional method is considered appropriate, it should be summarised and explained in the Strategy.

Liquidity of investments

24. The Annual Investment Strategy should set out procedures for determining the maximum periods for which funds may prudently be committed. This is to ensure that the authority has properly assessed the risk of committing funds to longer term investments. An investment should be regarded as commencing on the date the commitment to invest is entered into, rather than the date on which the funds are paid over to the counterparty.

Application to Parish Councils

25. The guidance will in certain cases apply to parish councils (and charter trustees), depending upon the level of investments they expect to have in a particular financial year. If that level is expected to exceed £500,000 during the year, the guidance should be treated as applying in full in relation to the whole year. Where investments are expected to exceed £10,000 but not £500,000, the council should simply make a formal decision on the extent to which it would be reasonable to adopt this guidance, either wholly or in part. For councils not expecting their investments to exceed £10,000, no action is necessary. However, such councils will of course be free to adopt the guidance if they wish.

GUIDANCE ON LOCAL GOVERNMENT INVESTMENTS

Issued by the Secretary of State
under section 15(1)(a) of the Local Government Act 2003

DEFINITIONS

1. In this guidance, **2003 Act** means the *Local Government Act 2003*
2. **Local authority** (except in paragraph 12(d) below) has the meaning given in section 23 of the 2003 Act (and in regulations made under that section). To the extent that this guidance applies to parish councils and charter trustees (see paragraph 6 below), a reference to a "local authority" includes those councils and trustees.
3. An **investment** is a transaction which relies upon the power in section 12 of the 2003 Act and is recorded in the balance sheet under the heading of investments within current assets or long-term investments. The term does not include *pension fund and trust fund investments*, which are subject to separate regulatory regimes and are therefore not covered by this guidance.
4. A **long-term investment** is any investment other than (a) one which is due to be repaid within 12 months of the date on which the investment was made or (b) one which the local authority may require to be repaid within that period.
5. A **credit rating agency** is one of the following three companies: *Standard and Poor's*; *Moody's Investors Service Ltd*; *Fitch Ratings Ltd*.

APPLICATION

6. This guidance applies in relation to the financial year 2004-05 and subsequent financial years. It applies only in England. It applies to all local authorities. It also applies to parish councils and charter trustees, subject to the following conditions:
 - (a) Where the parish council or charter trustee expects its investments at any time during a financial year to exceed £500,000, the guidance should apply in relation to that year.
 - (b) Where the parish council or charter trustee expects its investments at any time during a financial year to exceed £10,000 but not £500,000, it should decide on the extent, if any, to which it would be reasonable to have regard to the guidance in relation to that year.

(c) Where the parish council or charter trustee expects its investments at any time during a financial year not to exceed £10,000, no part of this guidance need be treated as applying in relation to that year.

ANNUAL INVESTMENT STRATEGY

7. The Secretary of State recommends that a local authority produces an **Annual Investment Strategy**, approved by the full council, that sets out the local authority's policies for managing its investments and for giving priority to the security and liquidity of those investments, as indicated in this guidance.

8. The Secretary of State considers that where the local authority is operating executive arrangements, it would be preferable for the local authority (ie the full council), rather than its executive, to approve the Strategy. Under Schedule 4 to the *Local Authorities (Functions and Responsibilities) (England) Regulations 2000 (S.I. 2000/2853, as amended)*, the authority has discretion to determine that the decision should be taken by them on whether the Strategy should be approved. The Secretary of State therefore recommends that they make such a determination.

9. For authorities without a full council, approval of the Strategy should be at the closest equivalent level.

10. Variations to the Strategy may be made at any time, subject to the same process of approval.

11. The Secretary of State recommends that the Strategy for any financial year should normally be approved before the start of that year. For the year 2004-05 only, it should be approved either before the start of the year or as soon as possible after the start. The Strategy and any variations should be made available to the public.

SECURITY OF INVESTMENTS

Specified Investments

12. An investment is a **specified investment** if:

- (a) the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;
- (b) the investment is not a long-term investment (as defined in paragraph 4);
- (c) the making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 3146 as amended]*; and

- (d) the investment is made with a body or in an investment scheme which has been awarded a high credit rating (see paragraph 13) by a credit rating agency (as defined in paragraph 5) or is made with any of the following:
- (i) the United Kingdom Government
 - (ii) a local authority in England or Wales (as defined in section 23 of the 2003 Act) or a similar body in Scotland or Northern Ireland
 - (iii) a parish council or community council.

13. For the purposes of paragraph 12(d) above, the Secretary of State recommends that the **Annual Investment Strategy** states:

- (a) how **high credit rating** is to be defined for the categories of investments which the local authority intends to use in the financial year
- (b) how and how frequently credit ratings are to be monitored and what action is to be taken when ratings change.

Non-specified Investments

14. With regard to non-specified investments (ie those not meeting the definition in paragraph 12), the Secretary of State recommends that the **Annual Investment Strategy**:

- (a) sets out procedures for determining which categories of such investments may prudently be used;
- (b) identifies which categories of such investments have so far been identified as prudent for use during the financial year; and
- (c) states the upper limits for the amounts which, at any time during the financial year, may be held in each identified category and for the overall amount which may be held in non-specified investments (the limits being defined by reference to a sum of money or a percentage of the local authority's overall investments).

LIQUIDITY OF INVESTMENTS

15. The Secretary of State recommends that the **Annual Investment Strategy** sets out procedures for determining the maximum periods for which funds may prudently be committed.