



# City of Westminster

<b>Decision Maker:</b>	<b>Cabinet</b>
<b>Date:</b>	<b>19 February 2018</b>
<b>Classification:</b>	<b>General Release</b>
<b>Title:</b>	<b>Integrated Investment Framework</b>
<b>Wards Affected:</b>	<b>All</b>
<b>Policy Context:</b>	<b>To manage the Council's finances prudently and efficiently.</b>
<b>Cabinet Member</b>	<b>Cllr T Mitchell, Cabinet Member for Finance, Property and Corporate Services</b>
<b>Financial Summary:</b>	<b>Implementation of an Integrated Investment Framework will influence investment decisions going forwards and deliver added value to Council services. This report identifies the potential for improved returns aspiring to match inflation in a full year compared with the current forecast return of 0.55%.</b>
<b>Report of:</b>	<b>Steven Mair, City Treasurer 020 7641 2831 smair@westminster.gov.uk</b>

## EXECUTIVE SUMMARY

1. Members will be aware that the 8 November 2017 meeting of Full Council gave approval to implement a comprehensive strategic integrated investment framework for bringing together and managing all of its investments.
2. The Council holds £1.4bn of short term cash based investments (as at 12 January 2018), managed under the Treasury Management Strategy, which passes through Scrutiny, Cabinet and Full Council on an annual basis. The Council also owns a significant number of Investment Properties, currently valued at £455m, which are considered as part of the Capital Programme, and holds longer term investments, mostly Government bonds and equity shareholdings. In addition, the Council is responsible for managing the Pension Fund which has net assets of £1.3bn, and operates under the Investment Strategy Statement (ISS) set by the Pension Fund Committee.
3. In summary, the Council holds £1.4bn of treasury investments for less than one year in high grade but very liquid investments, generating a forecast return of 0.55% and £0.4bn in much longer term illiquid property investments, generating around 4.2%. Compared with the current inflation rate as measured by CPI of 3.0% (as at January 2018), treasury investments are depreciating in value. The £1.4bn treasury portfolio

is 68% concentrated in the banking sector, and the property portfolio is concentrated within the borough. There is currently therefore limited diversification in the current investment portfolio.

4. This report sets out:

- the Council's strategic objectives in respect of risk management, and its attitude towards investment risk;
- current levels of investment activity;
- proposals for an Integrated Investment Framework for the Council going forward which seeks to diversify the risk and thus future-proof the Council against possible future economic downturns;
- actions to be taken in connection with implementing this Framework, if agreed.

## **RECOMMENDATIONS**

5. That the Council:

- a) approve and implement the Integrated Investment Framework set out in this report;
- b) approve that the target for the overall return on Council investments should aspire to match inflation;
- c) approve that the benefits of investing in the Pension Fund should be used as a benchmark when evaluating other investments;
- d) adopt the asset allocation percentages set out in the Framework and work towards achieving these;
- e) agree that the overarching objective of this Framework is to achieve an overall return on Council investments aspiring to match inflation, or to reduce costs and liabilities at an equivalent rate, whilst maintaining adequate cash balances for operational purposes, and not exposing the capital value of investments to unnecessary risk;
- f) approve that investments in out-of-borough property developments should be considered individually and should outweigh the benefits of investing in-borough (which can have a number of non-commercial benefits, e.g., place making) and in a diversified property fund. Individual decisions should be subject to Cabinet Member approval;
- g) approve that the property and alternative asset allocation should focus on in-borough, with out of borough options being explored as and when they arise and subject to Cabinet Member approval;
- h) approve the establishment of an Investment Executive, comprising the membership set out in paragraph 55, to implement, monitor and report on the investment strategy. The Investment Executive will meet half yearly, supplemented with ad hoc calls and meetings in times of change.

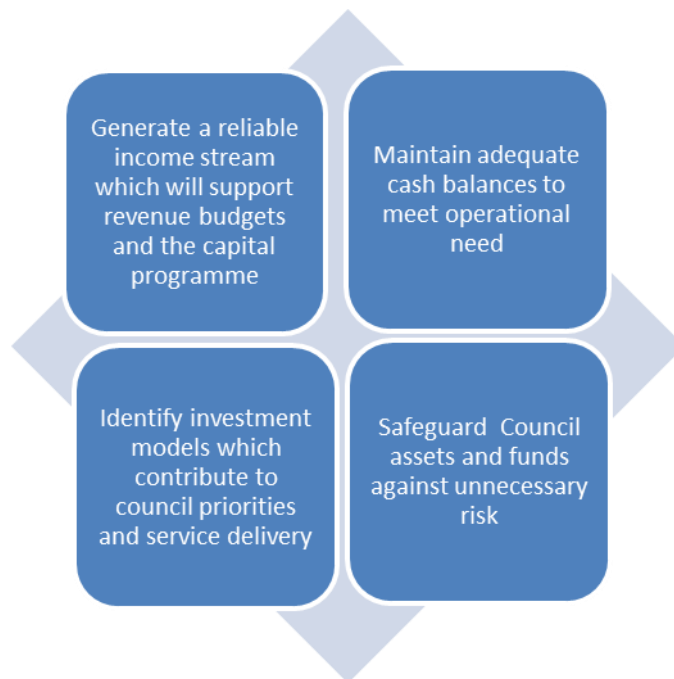
## **INTEGRATED INVESTMENT FRAMEWORK**

### **BACKGROUND**

6. The Council is responsible for managing its cashflows and assets exceeding £7bn at 31 March 2017. At 12 January 2018, investments totalled £1.8bn, comprising £1.4bn of short-term cash investments and £0.4bn of investment property. It is important that the Council is able to take a holistic view of its all its investment pools and align them with its funding needs and goals. The scale of these figures makes their positive and proactive financial management very important. Investments held as part of the Council's pension fund are managed under a separate regulatory framework and are outside the scope of this report from the point of view of investment management.
7. In previous years, the Council's Investment Strategy formed part of the Treasury Management Strategy Statement (TMSS) which is developed and updated as part of the Council's Medium Term Financial Plan (MTFP). The TMSS has tended to focus on the policies for placing short-term cash based investments, whilst decisions regarding other types of longer term investment have been considered on an individual basis as opportunities arose.
8. While the assets are distributed across a range of areas, the complexity of the Council and its funding need means that there is a need for the assets to be considered collectively and holistically as, in the aggregate, they represent a very significant pool of resources. More specifically, in view of:
  - the significant value of investments held by the Council;
  - their increasing importance in terms of generating income which supports revenue budgets and capital investment;
  - their potential to add value and contribute towards corporate objectives in their own right.
9. It was felt appropriate to give this aspect of financial management more detailed consideration and to develop a more integrated approach to investment decision making.

### **STRATEGIC CONTEXT**

10. The Council's key focus is on delivering high quality services within the context of reduced government funding and increased demand for services due to demographic change. The Council also needs to have regard to the longer term, given its moral and legal responsibilities regarding sustainability and stewardship of public assets.
11. The role of investment management is to support service delivery by balancing four key strategic objectives as follows:



12. An appropriate investment strategy which balances the above objectives is therefore key.
13. The Council is exposed to possible future events, such as:
- the potential impact of an economic downturn following the UK's exit from the EU, which could reduce the UK's gross domestic product (GDP) and increase demand for Council services;
  - more general economic dynamics because of the multiple links that the Council has into the economy through its service and revenue streams;
  - increases to pay and price inflation, which will place cost pressure on both revenue and capital budgets;
  - the pensions deficit which may result in increased employer contribution rates (although the Council has begun to address this);
  - interest rate changes which could materially impact on the cost of the capital programme;
  - Government funding policy changes.
14. Ideally, the investment strategy should be aimed at generating future income to address these longer term risks.

## ACCEPTABLE RISK LEVELS

15. An appropriate investment strategy which balances the above objectives consists of one which:
- focuses on investments with a reasonable return based on reasonable risk;
  - includes other Treasury opportunities not covered in the TMSS; and
  - investigates property investment opportunities.
16. The suggested policy going forward is that the Council will generally seek to obtain the maximum amount of income consistent with an optimum level of risk and will be willing to accept a lower level of income in exchange for a low risk product which does not expose the capital value of the investment to potential loss.

17. By more proactive and appropriate management of the Council's investment portfolio, an increased level of income can be achieved, but also ensuring that appropriate security is maintained over the Council's assets.
18. Such investments shall be separately identified in Council records and will be subject to the Council's detailed budget monitoring and review as a result.

## CURRENT INVESTMENT ACTIVITY

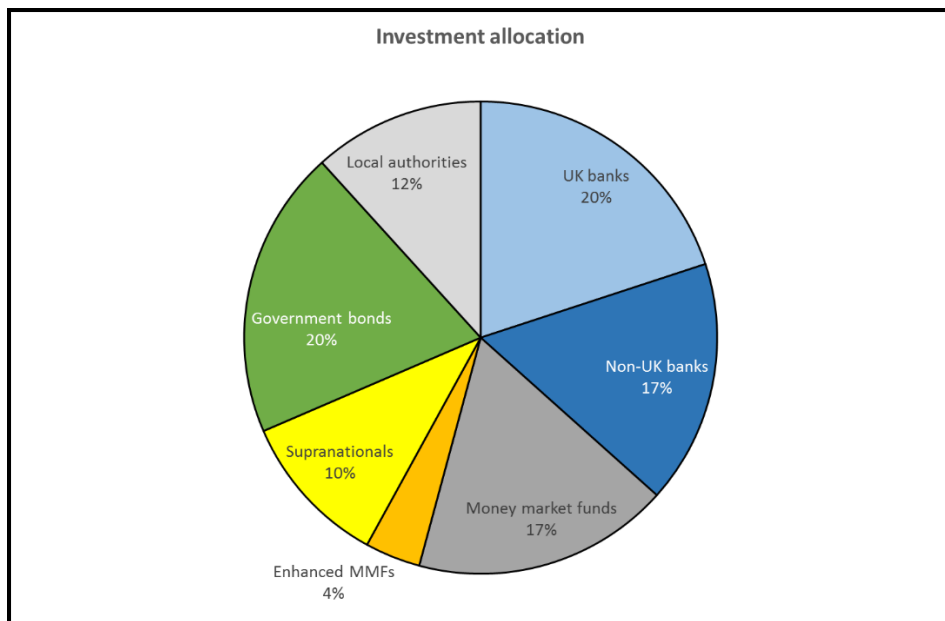
19. The Council is responsible for managing two broad investment portfolios:
  - the Council investment portfolio of £1.8bn comprising £1.4bn of short-term cash-based investments generating a forecast return of 0.55%, and the investment property portfolio of £0.4bn generating 4.2%, both managed entirely separately; and
  - the City of Westminster Pension Fund of £1.3bn which generates an average annual return of 9% measured over the past 10 years.
20. The Council investment portfolio (see below) is larger than any other local authority in the UK, exceeding not just the Council's own pension fund but over 40% of all local authority pension funds in England, Scotland and Wales.

Type of Investment	Expected rate of return	Value at 12 January 2018 £ million	Value at 31 March 2017 £ million	Value at 31 March 2016 £ million
Short term investments (mostly overnight cash deposits, money market etc.)	0.55%	1,374	743	515
Long term investments, mostly shareholdings in controlled companies such as CityWest Homes, Westminster Community Homes, WestCo trading etc.	Under 0.5%	41	41	46
Pooled property fund	6.0%	7	0	0
Investment properties	4.2%	455	455	405
<b>Total</b>		<b>1,877</b>	<b>1,239</b>	<b>966</b>

21. The Pension Fund is a separate legal entity and, therefore, its assets cannot fit within the wider investment framework of the Council. However, despite this ring-fencing, the pension fund has a significant second-order impact on the Council's financial position and funding needs, because of the existing deficit in the scheme, and the contribution plan in place to close this over a 17-year horizon.
22. Although the funding position of the Pension Fund has improved from 74% at March 2013 to 88% at September 2017, this still represents a liability of £171m. To close the deficit, the Council is injecting additional contributions over the period 2017/18 to 2019/20, comprising £30m of one-off resources and increased revenue contributions followed by inflation-linked levels of contributions thereafter until the deficit is resolved.
23. The funding of the Pension Fund assumes an annualised rate of return of 5.1% over the 17-year recovery period as represented in the discount rate used to value the pension fund liabilities. From the Council perspective, as an employer paying into the Pension Fund, the £171m deficit represents a form of borrowing with an interest rate set at the discount rate of 5.1%.

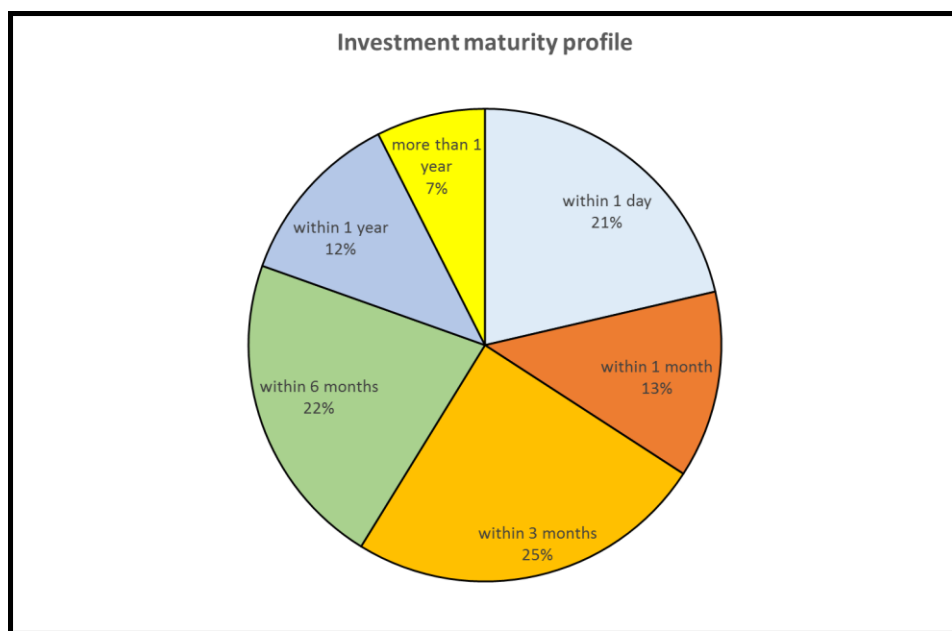
## SHORT-TERM INVESTMENTS

24. In line with the current investment strategy, the treasury portfolio of short term cash-based investments is concentrated in the banking sector with 37% in bank deposits, 21% in money market funds and 10% in supranational banks as shown below.



Source: TreasuryLive as at 12 January 2018

25. 93% of investments mature within 12 months as shown below.



Source: TreasuryLive as at 12 January 2018

26. In line with the above, the portfolio is entirely investment grade and heavily biased toward the top end with 69% of instruments AAA or AA rated, a further 30% A rated with only one BBB rated investment with RBS.
27. This approach provides flexibility for the Council at very low levels of risk, but tends to result in fairly low returns, typically less than 0.50%, and an approach to investment management which focuses very much on short-term return as opposed to longer term considerations. Overall, this points to the lack of an optimisation for maximising the yield versus credit rating.

## INVESTMENT PROPERTY

28. Commercial property investment provides investors with:

- a higher income return than equities, bonds or cash;
- a secure, regular income with income growth prospects to hedge against inflation;
- capital value appreciation;
- asset management opportunities to further increase rental and capital growth;
- an underlying real asset with minimum capital value.

29. However, as with any investment, there are associated risks:

- illiquidity: property is a 'bricks and mortar' asset which takes time to sell/buy;
- threat to income security if the tenancy fails and the property cannot be re-let;
- capital depreciation: if the asset is not properly managed and kept in good repair.

30. Geographically, the investment property portfolio is inevitably concentrated within the borough, which self-evidently tends to concentrate the economic risk in one area. Commercial property yields are currently ranging from 3.25% in central London to 5.50% in the regions (see Appendix C). In-house investment property generated 4.20% yield (excluding capital growth) in 2016/17.

31. Currently, the property portfolio is heavily fragmented due to its historical incremental build-up with a heavy concentration in car parks which generates 39% of total income, followed by shops generating 22%, offices generating 17% and other smaller units generating the remainder.

32. The car park assets, which provide a steady income stream, offer value added opportunities through potential change of use and redevelopment over time. The Council is focused on delivering best returns which acquiring new assets and redevelopment of assets to improve the quality of the portfolio should help to achieve.

33. An initial £50m drawdown facility for investment schemes to generate additional income towards future Medium-Term Plan savings was approved as part of the previous year's Capital Strategy. Of this £12.397m was invested leaving a balance of £37.613m. Additional funding of £50m has been added to the Capital Strategy 2018/19-2022/23 for this budget producing a total budget of £87.613m. Schemes funded by this will go ahead if they generate additional income after full due diligence.

34. A more focused property investment strategy is likely to increase returns by:

- setting out more clearly the process and goals of the strategy;
- providing a framework for rationalising lot size over time which will improve both efficiency and reduce the costs of managing the portfolio;
- targeting properties with a modern specification and minimal management costs;
- diversifying risk, sector and geography;
- improving asset quality and increase in average asset value.

35. An appropriate Property Investment Strategy will be agreed with members once the overall investment objectives of the Council are agreed. Focus should be on optimising performance of the Council's existing portfolio and acquiring adjacent/adjoining assets which will improve performance and delivery of active asset management of the portfolio.
36. Any strategy or future scrutiny of the Investment property portfolio should take into consideration any recommendations and requirements of the statutory guidance on local government investments, notably recommendations for the use of indicators in evaluating performance and viability of investments. Example indicators and background of the statutory guidance are included in Appendix D.

## **LONG-TERM INVESTMENTS**

37. Prior to 2004, Councils were only permitted to make loans to, or invest in, other local authorities, the Government, banks or building societies. The introduction of the Prudential Code relaxed these restrictions and gave local authorities the flexibility to invest in much more innovative methods of service delivery and income generation by:
  - establishing, controlling and participating in limited companies trading for profit; and
  - entering into loans and investments with “non-specified” counterparties, including limited companies and not-for-profit organisations.
38. These are classed as non-specified investments under the DCLG’s statutory guidance for local government investments.
39. No general legal restrictions are placed on the value, length or nature of such investments and the only proviso is that investments are placed in accordance with investment strategies formally approved by members. The City Council’s Treasury Management Strategy Statement (TMSS) expressly permits new investments in non-specified institutions. For any such investments, specific proposals will be considered by the Director of Treasury and Pensions, and approved by the s151 Officer subject to due diligence.
40. Non-specified investments include asset vehicles, such as infrastructure and housing, which offer additional possibilities. As well as generating additional income, they can, in and of themselves, make a contribution to corporate priorities and improve service delivery. They also diversify investment risk away from the banking sector and can offer more flexibility in terms of length of investment and timing of drawdowns.



41. This type of investment is becoming more common in local government with authorities investing in projects to increase low cost and affordable housing, improve transport infrastructure, and support sustainable energy programmes as well as pooled property or equity investments, venture capital funds to support new and growing businesses, bond issues and unit trusts.
42. Such investments typically offer returns of 4% to 8%. However, they also tend to carry more complex risk profiles and attract higher transaction/due diligence costs, and are unlikely to have a published unit price or credit rating. The onus therefore falls on the Council to make its own evaluation of the investment and whether or not to proceed.
43. The Council's current portfolio of non-specified investments is:

	Value at 12 January 2018 £ million	Value at 31 March 2017 £ million	Expected return
Investments in companies controlled or significantly influenced by the Council	14.4	14.4	Nil direct to the Council, profits made are usually reinvested in the business
Government (UK) gilts	24.9	25.6	0.50%
Supranational	73.7	0	0.52%
Other arm's length investments in companies	1.3	1.3	Occasional dividend income but no reliable income stream
Pooled property fund (Real Lettings)	6.6	0.0	Annualised 6% over 7-year life of fund
<b>Total</b>	<b>120.9</b>	<b>41.3</b>	

44. By increasing its holdings in this area, the Council would reduce its reliance on the banking sector and facilitate the move towards a more long-term investment profile, as discussed below.
45. Identifying and investigating individual investment opportunities across multiple markets can be both time consuming and expensive. Therefore, appointing a Fund Manager to manage a "bundle" of separate investments across a range of markets can be cost effective and spread risk by taking assurance on the fund manager's own due diligence processes.

## LIABILITIES AND CASHFLOW NEEDS

46. In order to assess appropriate changes to the treasury portfolio, it is important to consider also the council's liabilities and cashflow needs over time. This is imperative as the purpose of investing the assets is to better match upcoming cashflow needs and also to minimise funding gaps.
47. The Council has a significant capital programme, totaling more than £2.5bn to 2031/32. This will be funded from £1.2bn of external funding, leaving a net funding requirement of £1.4bn, as set out below.

	Forecast		Five year plan				Future	Total
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	years to	
	Within 1 yr	1-2 yrs	2-3 yrs	3-4 yrs	4-5 yrs	more than 5yrs	2030/31	
	£m	£m	£m	£m	£m	£m	£m	
Total expenditure	277	420	424	297	208	122	845	2,593
Total funding	(197)	(168)	(221)	(155)	(141)	(124)	(218)	(1,224)
<b>Net Funding Requirement</b>	<b>80</b>	<b>252</b>	<b>203</b>	<b>142</b>	<b>67</b>	<b>(2)</b>	<b>627</b>	<b>1,369</b>
% of treasury portfolio set against funding needs	6%	18%	15%	10%	5%	0%	46%	100%
<b>Suggested maturity allocation</b>	<b>10%</b>	<b>20%</b>	<b>15%</b>	<b>10%</b>	<b>5%</b>	<b>10%</b>	<b>30%</b>	<b>100%</b>

Source: Capital Strategy 2018/19 to 2022/23

## INVESTMENT ALLOCATION

48. The Council's investment portfolio is currently polarised between very short term cash based short-term investments on the one hand and commercial property, pension investments and equity shareholdings which tend to be held for perpetuity or at least 20 years or more.
49. Using the net funding analysis above rounded to the nearest 5% provides a suggested allocation by time which more appropriately reflects the Council's cashflow needs.
50. Therefore, the proposed approach going forward is to move investment allocations towards agreed percentages as follows:

Type of investment	Current allocation	Proposed allocation
Short-term investments – less than one year	69%	10%
Short-term investments – less than two years	6%	20%
Short-term investments – less than three years	0%	15%
Short-term investments – less than four years	0%	10%
Short-term investments – less than five years	0%	5%
<b>More than five years:</b>		
Property	25%	40%
Alternative investments	1%	

## OPTIONS FOR INCREASING YIELD

51. This will be achieved by making the following changes to the investment portfolio over the next 6 to 9 months. The following will be examined and assessed.

Change	Expected impact	Risk
<b>Treasury Management</b>		
1. Lengthen the maturity structure from the current average 7 months to a target average maturity of 2 years	By investing in longer maturity assets with same credit quality, some additional yield may be generated, but the gilt yield curve is relatively flat, so yields would likely increase by about 0.3%.	Going out to longer dated bank deposits beyond 5 years would increase counterparty risk to individual banks, which becomes more of a risk if there is a future financial crisis
2. Widen the credit quality of investments by moving from the current average rating of AA to A. This would allow the Council to invest a greater number of instruments with a moderate amount of credit risk (eg corporate bonds) that have maturity beyond one year. Yields tend to be higher to compensate for the higher perceived risk and reduced liquidity	For example, a portfolio of short duration investment grade sterling denominated credit benchmarked to the Barclays Sterling Corporate Bond index of 3 to 5 year maturities yields 1.24% currently, which is more than double the yield on the current treasury portfolio. The average credit rating of the index is BBB+/A	By diversifying away from bank deposits, although marginally lower credit rating, this would spread the risk in the event of a future financial crisis.
3. Add more credit sub-asset classes such as asset backed securities (ABS). These are typically listed rated bonds which can be traded, but liquidity varies depending on the issue. Types of credit include car loans, credit cards and residential mortgage backed securities (RMBSs)	Yields are in the range of 0.7 to 0.9%, greater than the current treasury portfolio. Yields can be higher for AA or A rated asset backed securities eg a 3 to 5 year A rated portfolio could yield 2.25%	The extra yield reflects the potential complexity of these instruments, but since the last financial crisis regulation has made asset backed securities more secure through risk retention rules, increased ratings scrutiny and credit protection, reflecting the government policy increasing lending to households and small businesses
<b>Investment property</b>		
4. Adopt a more focused property investment strategy by reducing the number of properties and increasing the lot size to efficiency gains and reduce the cost of management and maintenance. Given the added illiquidity of property investment, this only makes sense if the Council can achieve materially higher yields than the treasury portfolio and meet other objectives such as reducing risk (eg inflation) or help meet statutory duties. Therefore new acquisitions should: <ul style="list-style-type: none"> <li>• target a yield of at least 5%;</li> <li>• widen the scope of investments from in-borough</li> </ul>	Increased return on property portfolio of at least 0.8%.	Adverse property markets may result in a fall in sale value

<ul style="list-style-type: none"> <li>ensure the sale of resultant assets to repay any associated financing costs within an envelope of 5 years.</li> </ul>		
5. Expanding the use of fund structures to deliver specialist functions such as supported living housing, homeless shelters, asylum housing etc. This would meet statutory duties and generate a return	Yields from public social housing real estate investment trusts (REITs), such as the Real Lettings Fund which the Council is currently invested in are generating returns of 5 to 6.5%	By using a fund structure, this arms-length approach distances the Council from the costs of directly managing such property and investment is secured on the underlying property
<b>Alternative assets</b>		
6. These fall outside traditional investments, such as listed equities and bonds, and include renewable energy, infrastructure and commodities.		
7. A multi-alternatives approach could comprise investment in private asset-backed debt (such as pools of mortgages, car loans, credit card loans, aircraft leases, invoices, debt factoring and SME loans), direct lending and commercial real estate debt	Private asset backed debt tends to yield 4 to 6% with a maturity of 2 to 5 years. Direct lending and commercial real estate debt tend to generate 7 to 12% with a similar credit profile to bank loans	Risks can be managed by appropriate due diligence such as credit analysis. This type of investment can be fairly specialised, therefore this may be an area which would outsourced to a fund manager
<b>Pension Fund</b>		
8. Pension Deficit – invest an additional £50m to £60m in the pension fund over current contributions	This would reduce the interest on the pension fund deficit by 20% to 24% and thus improve the funding position by 18% to 22%, providing ongoing revenue savings of £1.7m to £2.0m per annum	Adverse markets in UK and abroad increase pensions deficit notwithstanding the additional investment made

## SCRUTINY

52. An investment task force was set up to ensure that the Council made best use of its resources and ensure value for money was being achieved in its investment strategy. The task force contains both Council Members and Officers.
53. The task force met on 13 September 2017 to perform an in depth review on the Council's wider investment framework document and provide suggestions improvements. The review looked at the council's property portfolio, short and long term treasury investments, governance arrangements and the impact of investing in the pension fund.
54. After the meeting the following recommendations were made:
  - the pension fund should be used as a benchmark for all Council investments due to the high long term rate of return;
  - council wide investments should aspire to match inflation;
  - property and alternative investments should be focused initially within the borough, with out of borough investments considered as they arise subject to member decision;

- investments in out of borough property should be considered individually and outweigh the benefits of investing in Borough (which can include non-commercial benefits e.g. Place making) and in a diversified property fund. Individual decisions should be subject to cabinet member approval.

55. Governance arrangements for the investment strategy should be closer aligned to the Pension Fund Committee. The body responsible can then report to the council where formal decisions on the investment strategy will be taken.

## **OVERALL INVESTMENT TARGET**

56. It is estimated that, after taking the actions outlined above, the Council should be able to achieve significant improvements in the overall level of investment income generated to support Council services.

57. The overarching objective of this Framework is to increase income generated from Council investments aspiring to match inflation in a full year (compared with the current forecast return of 0.55%), or to reduce costs and liabilities at an equivalent rate whilst, at the same time, maintaining adequate cash balances for operational purposes and not exposing the capital value of investments to unnecessary risk. However, because 60% of the current portfolio is held for more than six months and some of the higher return generating options have a lead-in time of one to two years before generating a return, the impact in the shorter term will be likely to be more modest depending on the options within the strategy.

## **GOVERNANCE**

58. Innovation within the financial services industry leads to a constantly changing market and the availability of new asset classes, products and financial instruments. The Council needs to be able to operate flexibly, and make decisions quickly, in order to benefit from the opportunities presented by this environment and to successfully implement the changes outlined above.

59. The implementation, management, monitoring and reporting of this Integrated Investments Framework will therefore operate as now, being approved by Full Council with specific investment decisions that require such action being delegated to the Cabinet Member for Finance, Property and Corporate Services after due diligence and advice from the City Treasurer and Tri-Borough Director of Treasury and Pensions.

60. Day-to-day aspects of treasury management function will continue to be delegated to officers in the same way that they are at present, but the Integrated Investment Framework will:

- enhance the effectiveness of decision making;
- embed a good risk culture that encompasses appropriate due diligence, option appraisal and an atmosphere of open debate;
- ensure that a holistic approach is taken towards managing the Council's portfolio.

61. The implementation, monitoring and reporting will be delegated to the Investment Executive. The Investment Executive will comprise:

- the Cabinet Member for Finance, Property and Corporate Services and the Chair of the Audit and Performance Committee;

- the City Treasurer, Tri-Borough Director of Pensions and Treasury, and the Director of Property and Investments;
  - the Chief Executive and the Executive Director GPH as necessary.
62. The Investment Executive will meet half yearly supplemented with ad hoc calls and meetings in times of need of change.
63. Key information will be reported to Members on a half yearly basis through the half yearly investment reports.
64. Given the complexity of this important area, the Council will need to rely on independent experts and advisors. Therefore, the Council will engage at least two investment advisors who will:
- provide advice on the current investment market and recommend new products in which to invest;
  - benchmark the Council's performance and identify any areas where there is scope for improvement.

## **DUE DILIGENCE**

65. Due diligence is any process undertaken to:
- investigate a business or person prior to signing a contract;
  - record the reasons behind an investment decision;
  - demonstrate that the Council is acting responsibly and has adequately assessed the balance between risk and reward.
66. Due diligence should be undertaken on all investments in a consistent manner, albeit proportionate, in terms of the value and complexity of the financial instruments being considered, and their relative impact on the Council's finances as a whole.
67. For a simple instrument such as a corporate bond, for example, a few paragraphs summarising risks and expected rewards, together with analysis from an advisor would suffice. A more complex product might require specialist assistance, comprehensive risk analysis and work undertaken to monitor and re-assess risks and performance regularly.
68. The Council has developed a framework for undertaking due diligence which promotes consistency and rigour whilst, at the same time, allowing for flexibility and a proportionate approach. It is based around the "6 Ps" principle as set out in Appendix A.
69. Whilst this framework does not rule out in principle any specific type of investment, all proposals will be considered in terms of:
- reputational risk to the Council;
  - environmental, social, ethical and sustainability considerations.

## **OPTION APPRAISAL**

70. An important aspect of due diligence is assessing the value for money offered by a new investment. Option appraisal will be undertaken for all new investments as part of the due diligence process, on a proportionate basis, that reflects investment value, expected duration, and anticipated level of risk. It will be:
- outcome focused;
  - structured around the key questions set out in Appendix B;
  - take non-financial benefits into consideration where relevant.
71. Option appraisal should focus on the opportunity costs of the investment and a comparison against returns offered by other products or opportunities realistically available, rather than achievement of a “theoretical” rate of return.

## **FINANCIAL AND LEGAL IMPLICATIONS**

72. This report identifies the potential for improved returns aspiring to match inflation in a full year compared with the current forecast return of 0.55%. Approval and implementation will result in an integrated framework for managing the Council’s investment portfolio which supports improved returns and a more effective contribution to Council priorities and services.
73. A full review of the proposed Framework will be undertaken by Legal Services to ensure compliance with all legislative requirements and consistency with the Council’s existing Constitution, terms of reference and scheme of delegation.

## **RECOMMENDATION**

74. That Members:
- a) approve and implement the Integrated Investment Framework set out in this Report (to be reviewed on an annual basis);
  - b) approve the target for the overall return on Council investments should aspire to match inflation;
  - c) approve the benefits of investing in the Pension Fund should be used as a benchmark when evaluating other investments;
  - d) adopt the asset allocation percentages set out in the Framework and work towards achieving these;
  - e) agree that the overarching objective of this Framework is to achieve an overall return on Council investments aspiring to match inflation per annum, or to reduce costs and liabilities at an equivalent rate whilst maintaining adequate cash balances for operational purposes and not exposing the capital value of investments to unnecessary risk;
  - f) approve that investments in out-of-borough property developments should be considered individually and should outweigh the benefits of investing in-borough (which can have a number of non-commercial benefits e.g. place making) and in a diversified property fund. Individual decisions should be subject to Cabinet Member approval;

- g) approve that the property and alternative asset allocation should focus on in-borough, with out-of-borough options being explored as and when they arise and subject to Cabinet Member approval;
- h) approve the establishment of an Investment Executive, comprising the membership set out in paragraph 55, to implement, monitor and report on the investment strategy. The Investment Executive will meet half yearly supplemented with ad hoc calls and meetings in times of change.

## **BACKGROUND PAPERS**

### **Overview and scrutiny**

Treasury Monitoring Report – January 2018

### **Council**

2018/19 Draft Treasury Management Strategy - January 2018

2018/19 Council Tax and Capital Strategy – November 2017

2017/18 Statement of Accounts – April 2017

**If you have any queries about this Report or wish to inspect any of the Background Papers, please contact:**

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## **APPENDIX A – DUE DILIGENCE FRAMEWORK**

1. The Council has developed a framework for undertaking due diligence which promotes consistency and rigour whilst at the same time allowing for flexibility and a proportionate approach. It is based around the “6 Ps” principle as set out below:

### **Powers**

- a) What legal powers is the Council relying on to make the investment being proposed;
- b) Has legality been considered in terms of the underlying nature of the activity, as well as the instrument or vehicle itself?
- c) Have capital financing and MRP requirements been considered?

### **Permission**

2. Does the Council need permission from the Secretary of State or anyone else before progressing this investment e.g.,
  - a) Members – and if so who (committee with delegated authority, cabinet or full Council)
  - b) Chief Officer if delegated decision making powers apply
  - c) Consultation with the public or staff may be a legal requirement
  - d) Does the proposal involve legal negotiations with a contractor or 3rd party?

### **Policy**

- a) Does the proposal fit within the Council’s policy objectives in terms of what it is trying to achieve?
- b) If not does the proposal need to go to Full Council for approval?

### **Payment**

- a) How is the proposal to be funded both in terms of initial and ongoing costs (i.e. is there a budget – revenue and capital)

### **Procurement**

- a) Has the proposal been subject to the Council’s procurement procedures?
- b) Does it need to go through formal tendering or does it need a waiver?
- c) Are there any State Aid or EU implications?

### **Press**

- a) Might the Council be exposing itself to criticism?

3. Whilst not all of the above considerations will apply to every investment scenario, this framework will be applied in principle to every investment proposal, with results reported to Members for consideration.

## APPENDIX B – OPTION APPRAISAL

1. Option appraisal should be structured around the following questions:

Key questions	Issues to consider
How is the proposal to be funded in terms of initial and ongoing costs?	Is there an existing budget or is virement required? Does the proposal provide any added value to the Council in terms of improved efficiency, budget savings or reduced costs?
What is the opportunity cost of using up these cash resources?	What is the expected length of the investment period? What additional costs are there (transaction costs, due diligence etc.) in addition to the capital investment itself? Does the expenditure count as a capital transaction under capital accounting regulations? If so what are MRP/CFR implications? * Is there an exit strategy? Will this involve additional costs? Is there a risk of permanent impairment in the capital value of the investment?
Does the proposal link to corporate objectives and statutory services?	If so how does it compare to the cost of achieving similar outcomes? Will this delivery option increase or decrease outcome or cost risk?
Is the proposal solely to generate income?	What key assumptions and sensitivities are contained in the financial model? * What are best, worst and medium case scenarios? How do these compare to other investment opportunities within the same investment allocation?
What transaction, professional and management costs need to be considered?	Consider for example:  Independent advice and “experts” Legal fees/stamp duty Tax, audit, accountancy, secretarial Officer time in attending meetings etc.

\* To promote consistency when evaluating potential investments, any MRP set aside requirements for property or alternative investments will be calculated using the annuity method rather than on a straight line basis.

## APPENDIX C - Prime yields for commercial property

	Feb 16	Feb 17	Jun 17
West End offices	3.00%	3.25%	3.25%
City Offices	4.00%	4.00%	4.00%
Offices M25	5.00%	5.25%	5.25%
Provincial Offices	4.75%	5.25%	5.25%
High Street Retail	4.00%	4.00%	4.00%
Shopping Centres	4.25%	4.50%	4.50%
Retail warehouse (open A1)	4.50%	5.25%	5.25%
Retail warehouse (restricted)	5.25%	5.75%	5.75%
Food stores	5.00%	5.00%	5.00%
Industrial distribution	4.50%	5.00%	5.00%
Industrial multi-lets	4.75%	4.75%	4.50%
Leisure Parks	5.00%	5.00%	5.00%
Regional Hotels	5.50%	5.25%	5.00%

Source: Savills

## APPENDIX D – Performance indicators

Statutory guidance on Local Government Investments proposes that:

Local authorities should present a range of indicators to allow members and other interested parties to understand the total exposure from borrowing and investment decisions. The indicators should cover both the local authority's current position and the expected position, assuming all planned investments for the following year are completed. The indicators do not need to take account of Treasury Management investments unless these are expected to be held for more than 12 months.

The Guidance requires local authorities to develop quantitative indicators that allow Councillors and the public to assess a local authority's total risk exposure as a result of its investment decisions.

Below are examples of performance indicators worth considering within a property investment portfolio.

Target income returns	Net revenue income compared to equity. This is a measure of achievement of the portfolio of properties.
Benchmarking of returns	As a measure against other investments and against other council's property portfolios.
Gross and net income	The income received from the investment portfolio at a gross level and net level (less costs) over time.
Operating costs	The trend in operating costs of the non-financial investment portfolio over time, as the portfolio of non-financial investments expands.
Vacancy levels and tenant exposures for non-financial investments	Monitoring vacancy levels (voids), ensure the property portfolio is being managed (including marketing and tenant relations) to ensure the portfolio is productive as possible.