National Audit Office

Report
by the Comptroller
and Auditor General

Ministry of Housing, Communities & Local Government

Local authority investment in commercial property

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Key facts

£6.6bn
estimated local authority spend on commercial property from 2016-17 to 2018-19

49
out of 352 local authorities accounted for 80% of commercial property spending during 2016-17 to 2018-19

17.5%
of all commercial property acquisitions by value in the South East during 2016-17 to 2018-19 were made by local authorities

28.7%	real-terms reduction in local authorities' spending power (government funding and council tax) from 2010-11 to 2019-20
14.4 times	more spend on commercial property acquisitions by local authorities in the period 2016-17 to 2018-19 compared with the preceding three years
38.0%	of local authorities' commercial property acquisitions by value in the period 2016-17 to 2018-19 were outside their boundary
£2.3 billion	spent by local authorities on retail properties in the period 2016-17 to 2018-19
£14.3 billion	increase in the stock of external borrowing held by local authorities between the end of March 2016 and end of March 2019
100 basis points	added to Public Works Loan Board lending rates in October 2019 by HM Treasury in response to increased borrowing in preceding months

Summary

1 In response to substantial falls in funding since 2010-11, local authorities have made reductions in revenue spending on services. Increasingly, authorities have also sought to offset funding reductions by generating new income through a range of strategies. A key component within these responses has been a rapid expansion in the acquisition of commercial property, often funded by borrowing.

2 Buying commercial property can deliver benefits for local authorities including both the generation of income and local regeneration. However, as with all investments, there are risks. Income from commercial property is uncertain over the long term and authorities may be taking on high levels of long-term debt with associated debt costs, or may become significantly dependent on commercial property income to support services. At the national or regional level, local authority activity could have an inflationary effect on the market or crowd out private sector investment.

3 Local authority spending on commercial property takes place in the context of the prudential framework, made up of both powers and duties created by legislation and a set of statutory codes and guidance to which authorities must have regard. The framework gives local authorities significant autonomy over their capital spending and resourcing. Local authorities can borrow to support capital spending and the framework allows each authority to borrow within the overall level they decide is affordable. The codes and guidance seek to restrict borrowing purely in order to profit from investing the borrowed money. There are no restrictions where commercial property purchases are resourced by capital receipts or revenue funding.

4 The Ministry of Housing, Communities & Local Government (the Department) has overall policy responsibility for the prudential framework. It is also responsible for the wider local government finance system. The Department's responsibilities include:

- ensuring that the prudential framework is functioning as intended, and making effective changes where necessary;
- understanding the risks to local government finance from changes in local authorities' borrowing and investment activities; and
- maintaining a framework that gives assurance about how local authorities use their resources, including risks of financial failure.

5 HM Treasury (HMT) is in practice accountable for funds loaned by the Public Works Loan Board (PWLB) to local authorities. PWLB is an independent statutory body that has delegated its day-to-day operations to the Debt Management Office, an executive agency of HMT. HMT decides the cost of the loans, which currently are set relative to government borrowing costs, but PWLB's commissioners (effectively its board) retain a number of powers over lending terms. PWLB loans are quick and straightforward for local authorities to access, and the rates are not dependent on an assessment of an authority's specific credit risk. HMT is accountable for the source of PWLB loans: the National Loans Fund, central government's main borrowing and lending account. HMT also has an interest in the functioning of the wider economy and the government's fiscal framework. The Chartered Institute of Public Finance and Accountancy (CIPFA) is responsible for producing elements of the prudential framework. The Department retains ultimate policy responsibility for the prudential framework and accompanying legislation.

Our report

6 Our report examines whether the framework overseen by the Department allows for the management of risks to the financial sustainability of local authorities from investment in commercial property. We expect the Department to have clear objectives for the system and enough information and assurance on its functioning. We also expect the Department to make effective changes when required.

7 The report addresses this question in four parts:

- Part One sets out the framework within which local authority spending on commercial property takes place.
- Part Two examines recent trends in local authority commercial property acquisition.
- Part Three examines the extent to which authorities are exposed to different risks because of their commercial property acquisitions, and the steps they are taking to mitigate risk.
- Part Four examines how the Department is discharging its responsibilities for the system for local capital spending in relation to investment in commercial property.

8 Our report does not directly assess either national or local risks to value for money from local authorities' acquisition of commercial property. The report focuses on the ability of the Department and HMT to assure themselves about risks to value for money. We include local data and case study material to inform our review of the Department's and HMT's work. We make no assessment of whether these local activities represent value for money or if they involve excessive risk.

Scope of our work

9 Local authorities have undertaken a wide range of income-generating activities in recent years, from revising their fees and charges strategies to investing in renewable energy schemes or setting up companies to provide traded services. However, in this report, we focus solely on the acquisition of non-residential commercial property. This means property for business use generally let to tenants for a commercial rent. While our primary interest is in investments focused on yield (financial return) rather than regeneration and place-shaping, we recognise that many purchases will have multiple objectives. Given this, we do not restrict our scope to a legal definition of investment or the accounting definition of investment properties. Instead, we consider acquisition of commercial property more widely.

Key findings

Local authority investment in commercial property

10 The acquisition of commercial property has become a significant area of activity for some authorities in recent years. While local authorities have held properties for investment purposes for many years, the period 2016-17 to 2018-19 saw a step-change in scale. We estimate that authorities[1] spent £6.6 billion on commercial property from 2016-17 to 2018-19: 14.4 times more than in the preceding three-year period (paragraphs 2.5 and 2.6, and Figure 3).

11 The bulk of commercial property acquisition is undertaken by a relatively small, albeit growing, group of authorities. Some 80% of the cumulative spend in the sector over the period 2016-17 to 2018-19 is accounted for by only 49 local authorities (13.9%). However, 105 authorities had spent at least £10 million on commercial property in this period. District councils are disproportionately active relative to their size. There is also a strong geographical skew: authorities in the South East accounted for 52.9% of acquisitions by value from 2016-17 to 2018-19 (paragraphs 2.10 to 2.13 and Figures 5 to 8).

12 Local authorities acquire commercial property for a variety of reasons, but yield is currently an important factor. In our review of 45 authorities' capital strategies, all but three identified yield as a significant objective underlying their commercial property acquisitions. Furthermore, a substantial amount of spending is on property outside authorities' boundaries, including 47.9% of all acquisitions by value in 2018-19. In general, spending within an authority's boundaries may have local policy objectives in addition to generating yield. In contrast, out-of-area acquisitions are more likely to be predominantly for yield. Data on the net yields achieved by authorities is limited. Of the 13 strategies where we could identify net yields which accounted for authorities' full debt costs, 11 reported net yields of no higher than 2.6% (paragraphs 2.14 to 2.25, 3.24 and Figures 9 to 11).

1 We define 'local authorities' as principal councils. These include metropolitan borough councils, unitary authorities, London borough councils, county councils and district councils. We include the Isles of Scilly. However, we exclude the City of London. See Appendix Two.

Risks and risk management

13 **There are inherent potential risks associated with the acquisition of commercial property.** These include 'specific risk' associated with each individual property such as the length of the lease or the financial strength of the tenant. Local authorities also face 'systematic risk', which reflects movements in markets; in the last recession UK commercial property values and market rental values both fell. In recent years, systematic risk is apparent in the performance of the retail sector with the shift to online sales, among other factors, leading to growth in vacancy and void rates. The implications of these risks, should they materialise, will depend on the level of exposure of individual authorities' finances to their property portfolios, and the capacity of their governance to mitigate these risks (paragraph 3.12).

14 **Borrowing has played an important role in supporting the acquisition of commercial property but it is not possible for the precise extent of this to be quantified.** Authorities' capital programmes are resourced as a whole from multiple sources, rather than by linking individual purchases to specific funding or financing lines. Consequently, it is not possible to identify the amount of borrowing used to support commercial property acquisition across the sector. However, for the £6.6 billion spent on commercial properties from 2016-17 to 2018-19 we estimate that between a maximum of £6.0 billion (91.2%) and a minimum of £2.5 billion (38.5%) of this spend was financed by prudential borrowing. Prudential borrowing includes external borrowing, and also 'internal borrowing'; a treasury management practice whereby an authority temporarily uses cash it is holding for other purposes (paragraphs 1.5 to 1.7 and 3.2 to 3.5, and Figure 12).

15 **External borrowing to support commercial property investment is likely to have accounted for a proportion, but not all, of the growth in the stock of external borrowing across the sector in recent years.** Local authorities' stock of external borrowing increased by £14.3 billion from 2015-16 to 2018-19, taking total external borrowing held to £74.6 billion. The stock of borrowing from PWLB increased by £10.3 billion in this period. However, borrowing for commercial property investment alone does not account for the increase in the stock of borrowing across the sector since 2015-16. For instance, single-tier and county councils spent £3.2 billion on commercial property from 2016-17 to 2018-19, but their stock of external borrowing increased by £10.1 billion over the same period. It is not clear what is driving this additional borrowing. Both the Department and HMT are currently assessing the underlying reasons, however (paragraphs 3.5 to 3.9 and Figure 14).

16 **In October 2019 HMT announced a one percentage point increase in the cost of new PWLB loans due to substantially increased use of PWLB lending in previous months.** HMT wanted to ensure that there was sufficient headroom within PWLB's statutory limit for authorities to continue to borrow over the medium term. HMT told us the rise is not connected specifically to local authorities' borrowing for commercial property investment. However, in our view some authorities who had been planning to use PWLB lending to support future commercial property acquisition might now reconsider their plans (paragraphs 3.11 and 4.16).

17 A small group of authorities have seen significant increases in their external borrowing and debt servicing costs linked to the acquisition of commercial property. Authorities that have acquired commercial property in recent years are more likely to have seen increases in their stock of external borrowing and debt servicing costs than those that have not acquired commercial property. However, in general these increases are not especially marked. A notable exception is the small group of district councils (8.5% of district councils) that have been most active in the acquisition of commercial property. This group saw their stock of external debt increase by £88.8 million at the median, and median gross external borrowing levels grow from 3% to 756% of their spending power from 2015-16 to 2018-19. However, in the absence of detailed information on the contribution made by commercial property to authorities' revenue budgets and their contingency arrangements, it is hard to assess fully the financial risks to which authorities are exposed (paragraphs 3.5, 3.13 to 3.17 and Figures 13 to 18).

18 There are potential market distortion and value-for-money risks generated by local authorities' acquisition of commercial property. We estimate that local authorities accounted for 4.9% by value of commercial property acquisitions from 2016-17 to 2018-19 in England. However, over this period, authorities accounted for an estimated 9.4% of all commercial property acquisitions outside of London, including 17.1% of retail and 27.1% of office acquisitions in the South East. The geographic and sectoral concentration of authorities' acquisitions could have market-distorting effects, including distorting prices for other authorities. A further potential value-for-money risk is that the relatively low rates available to authorities through PWLB might have led to authorities being able to pay a premium above the market rate to acquire property (paragraphs 3.28, 3.29, 3.31 and Figure 20).

19 External auditors we spoke to considered there are clear areas for improvement in some authorities' governance and risk management arrangements for their commercial property acquisitions. There was evidence from our case study and workshop discussions that authorities had taken steps to manage the risks of their commercial property acquisitions. Separately, auditors said that they had observed authorities demonstrating good practice in governance, but also weaknesses in some authorities including insufficient transparency and reporting to elected members or the public; limited internal challenge to decision making; reduced governance to enable faster decision-making; and limited capacity and skills at officer level. They did not express acute concern about these arrangements across the sector though. In two instances, auditors have qualified their conclusions on an authority's value-for-money arrangements in relation to acquisition of commercial property (paragraphs 3.32 to 3.35).

The government's stewardship role

20 **The Department is responsible for a statutory framework, including codes and guidance, that set the parameters for local authority borrowing and capital spending.** Local authorities' borrowing and investment activities take place within the prudential framework, made up of legislation supported by four sets of statutory codes or guidance. The Department produces two sets of guidance. CIPFA is the author of the prudential and treasury management codes. The then Secretary of State chose to specify these codes in regulations and therefore the Local Government Act 2003 requires authorities to "have regard to" them. Ultimately, the Department is responsible within government for the prudential framework legislation, which includes the requirements for authorities to have regard to the statutory codes or guidance (paragraphs 1.9 and 1.15, and Figure 1).

21 **The Department needs to improve its evidence base on both the nature and scale of local authorities' commercial property investments and any associated risks, and framework compliance.** The Department needs sufficient and proportionate data and analysis to allow it to understand sector-wide patterns relating to risk and framework compliance, and to allow it to focus on particular practices or authorities if necessary. The Department has data on local authority debt levels and costs and it has used these to support its work on the financial sustainability risks of commercial investments. However, there are a range of other areas such as trends in buying out of area, the contribution of commercial income to service expenditure, and the scale of contingency funds where the Department needs better and more timely data and analysis. The Department could look to review the data it collects nationally, as it has in the recent past, or alternatively engage with third-party providers or encourage the routine provision of certain data within authorities' capital strategies. The Department has also not yet addressed other potentially significant issues sufficiently, including potential sub-regional and sectoral market distortion (paragraphs 4.3 to 4.12 and 4.28).

22 **The Department and CIPFA changed key aspects of the codes and guidance two years ago in response to rapid growth in spending on commercial property and in levels of borrowing, among other changes.** The Department's actions were partly in response to a Committee of Public Accounts report in November 2016. Both CIPFA's and the Department's changes aimed to reinforce the existing point that "Authorities must not borrow more than, or in advance of their needs purely in order to profit from the investment of the extra sums borrowed". The implication of this is that authorities should not borrow to invest solely for yield. However, while an authority must have regard to the codes and guidance, it can choose not to follow them. In such cases the authority must still assure itself that it has appropriate legal powers to support its actions and has met its statutory duties, and it must now explain the rationale for the approach in its capital strategy (paragraphs 4.15 to 4.19 and Figure 21).

23 The Department has not yet fully tested whether the changes to the framework have had an impact on the nature and scale of risk in the sector. The Department is reviewing the impact of the changes to its guidance, which is positive, but in our view the review does not go as far as it could have done as it took a purely qualitative approach and defined the impact the Department wanted to achieve in terms of decision-making behaviour, as this was the intended direct effect of the guidance changes. The Department did not have clear measures to test the impact of the changes on risk from commercial property investment and did not carry out new quantitative analysis of commercial investment activity in the sector. The Department has told us it has subsequently decided this work will form a first phase of its review and that this work was scoped to provide an initial review of early progress. The Department will review trends in the sector in later phases of its review work (paragraphs 4.15, 4.18 and 4.21).

24 Levels of spending on commercial property at the sector level have remained largely unchanged following the recent changes to the framework. Our analysis shows that the level of commercial property acquisitions remained largely unchanged up to September 2019, 18 months after the first elements of the new guidance came into force and six months after the last element came into force. We estimate that local authorities spent £2.2 billion on acquiring commercial property in 2018-19 and a further £1.0 billion in the first half of 2019-20. Some 47.9% of this spending in 2018-19 was on property outside authorities' areas. We estimate that between 89.2% and 48.0% of authorities' spend on commercial property in 2018-19 was financed by prudential borrowing. The Department told us it did not expect an immediate, significant change in response to the new guidance and that the Department's objectives are focused on improving decision-making behaviour (paragraphs 2.5, 2.23, 3.3, 3.7 and 4.21, and Figures 3, 10 and 21).

25 Recent trends and practices in commercial property investment raise questions about aspects of the prudential framework and its oversight in the current context. Affordability, a key duty underpinning the borrowing arrangements at the heart of the prudential framework, is no longer effective in constraining each authority's overall borrowing by keeping it linked to their ability to fund borrowing costs from government grant or local tax. Currently, some authorities are taking on general fund debt in high multiples of core spending power and view it as affordable because of the income their commercial property investments generate. Equally, the framework's permissive nature is now being tested. The experiences of recent years have shown that in the context of sustained financial pressure, some authorities, perhaps inadvertently, will test the limits of compliance. This shift in borrowing for income-generating opportunities requires greater changes to the Department's oversight of the effectiveness of, and compliance with, the framework at the sector level than we have seen to date. Furthermore, the nature of the framework means that it can be slow to change. While commercial behaviour changes emerged in 2016-17, it took until 2018-19 before the codes and guidance changes started to come into effect, with the Department not expecting an immediate change in behaviour in that year (paragraphs 1.9, 1.10, 2.18, 3.13, 4.15, 4.23 and 4.29, and Figures 15 and 21).

Conclusions on value for money

26 The acquisition of commercial property can enable authorities to generate income in the context of financial pressure, while also supporting regeneration. However, the scale of investment of public funds in this activity in the last three years, the concentration of this activity in a relatively small group of authorities, and the use of borrowing to finance such investments is striking. The benefits from this investment therefore must be considered against the potential financial sustainability and value-for-money risks that have emerged.

27 The Department as steward of the prudential framework, alongside CIPFA, has sought to address the implications for the framework of emerging risks from these activities. It has been alive to the financial sustainability risks for a small number of authorities and has made system changes in response. However, the Department is only expecting gradual change in those authorities' behaviour despite the Committee of Public Accounts first highlighting concerns in November 2016.

28 The position set out in this report raises questions about the extent to which the Department and HMT can rely on the prudential framework in its present form to support value-for-money decision-making in the current legal and financial context. The permissive nature of the prudential framework has been tested by new behaviours in the sector, and the Department has not yet responded in a timely way that also reflects the marked variations in activity across the sector. To protect against risks to value for money, the Department must take steps to ensure that authorities' actions are in line with the principles underlying the framework. To support this, it should strengthen framework oversight and develop methods for more timely, flexible and targeted intervention when required.

Recommendations

a **The Department should improve the relevance and quality of data and analysis it has on authorities' acquisition of commercial property to understand more fully any associated risks and to provide greater assurance on framework compliance.**

b **The Department, with HMT as appropriate, should broaden its analytical work on local authority commercial property acquisition to:**

- assess potential market-distortion effects;
- understand any value-for-money risks associated with access to PWLB borrowing; and
- assess the investment risks that the sector as a whole is exposed to through the national 'portfolio' of investment properties.

c **The Department needs to articulate clearly both the nature and scale of behaviour causing it concern in relation to both borrowing in advance of need and disproportionate borrowing.** It should:

- monitor trends more actively at sector level to understand compliance; and
- assure itself that it has sufficiently flexible forms of intervention supported by robust evidence to enable it to target particular behaviour.

d **The Department, working with CIPFA as appropriate, should review the prudential framework, its oversight and intervention arrangements, and underpinning data to ensure they remain fit for purpose in the context of an increase in local authority commercial activity.** In doing this the Department should:

- examine whether varying interpretations of the authorities' borrowing and investment powers in the sector are having an impact on the resilience of the prudential arrangements; and
- review recent changes in local authorities' investment and borrowing activities and their underlying motivations to understand fully:
  - the drivers behind recent changes in behaviour in different types of authority, and the relative importance of each driver;
  - the extent to which authorities have undertaken activities that test the limits of the framework such as borrowing to invest solely for yield;
  - the extent to which changes to the codes and guidance have genuinely changed behaviour or whether other factors such as the recent rise in the PWLB rate might have been more significant; and
  - whether recent changes to the codes or guidance have had any unintended consequences that may have increased risk.