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Local authority investment in commercial property

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Local authorities spent an estimated £6.6 billion of taxpayers' money acquiring commercial property in the three years to 2018–19. This is over 14 times more than in the previous three-year period, and is primarily a response to a sustained period of funding reductions. Local authorities spent a further £1bn in the first half of 2019-2020 authorities have predominantly acquired these potentially risky commercial investments in order to secure yield from rental income. Up to 91% of commercial property spending in the three years to 2018–19 has been financed by prudential borrowing. By 'borrowing for yield' to offset their financial pressures, some authorities have built up substantial long-term debts that need to be serviced by rental incomes that are far from guaranteed. This risky approach is not within the spirit of the framework within which local authority borrowing and investment takes place, and which is overseen by the Ministry of Housing, Communities & Local Government (the Department).

In 2016 this Committee warned that the Department, "appears complacent about the risks to local authority finances, council tax payers and local service users resulting from local authorities increasingly acting as […] commercial landlords with the primary aim of generating income". It is therefore deeply disappointing to see huge increases in this activity since 2016. We are concerned that the Department is blind to the level of exposure of the local government sector to sectoral commercial risks. If a commercial sector collapses or underperforms it is vital that the Department has a better grasp on the likely impact on council finances. This is important because an individual council investment may pass muster with the auditors, but cumulatively the risk could be great and the impact falls on local council tax payers and service users. COVID-19 has just served to underline the Committee's concerns.

The Department's attempts to improve its data and to strengthen guidance to the sector have not been sufficiently urgent and have failed. The Government data was so limited that the NAO had to purchase outside commercial data in order to complete their report. Recent proposals from HM Treasury to prevent borrowing for yield may prove to be more effective. However, the imposition of such hard controls is the result of the Department's failure to prevent or publicly confront behaviour that breaches the spirit of the prudential framework, and should not have been necessary. This is also a clear case of reactive, rather than proactive, policy making. The Department must learn from this experience and take steps that are robust enough to cope with future challenges in the sector. A key challenge will be striking a better balance between supporting localism and ensuring that authorities act within the frameworks that underpin local freedoms.

Introduction

Local authorities have a range of powers to acquire commercial property. In some instances, authorities also have powers to finance these investments through borrowing. This legal framework allows them to secure properties to support their regeneration, local growth and place-making activities. Local authority borrowing and investment takes place within the prudential framework, made up of powers and duties and a set of statutory codes and guidance to which authorities must have regard. New codes and guidance were published in December 2017 and February 2018, following our 2016 report, but they are clearly not being complied with by some local authorities. Local authorities have a high degree of autonomy within this framework and can set their borrowing at whatever level they decide is affordable. The codes and guidance seek to restrict borrowing purely for the purpose of profiting from investing the borrowed money. According to the Chartered Institute of Public Finance and Accountancy (CIPFA) borrowing purely to invest for yield has traditionally been presumed to be unlawful, unless undertaken by an arms-length trading company. The Ministry of Housing, Communities & Local Government (the Department) has overall policy responsibility for the prudential framework alongside its wider responsibility for the overall local government finance system. This means the Department is ultimately responsible for ensuring the prudential framework is functioning as intended and understanding and monitoring the risks to local authorities' finances from their borrowing and investment activities. The integrity of the prudential framework, and the Department's role in ensuring the framework functions effectively, have become increasingly important as local authorities have responded to a sustained period of funding reductions by generating income through a variety of commercial investment models.

Conclusions and recommendations

1. **The Department has been complacent while £7.6 billion of taxpayers' money (including the extra £1bn spent in the first half of 2019–20) has been poured into risky commercial property investments.** In 2016 this Committee reported that the Department appeared complacent in relation to local authorities increasingly acting as commercial landlords. Since then, investments have ballooned 14-fold, demonstrating that the Department remains just as complacent as it was four years ago. The Department has taken modest steps to improve data and strengthen its guidance after realising that there is an issue with the borrowing and investment behaviour in parts of the sector. However, these actions have not been sufficiently timely or robust and have not proved effective. The Department's limited response seems to reflect the fact that it is keen to preserve the local freedoms provided by the prudential framework. As part of this the Department downplays the true nature and scale of the issue. The Department referred to "a handful" of councils where they have concerns, and also argued that investing solely for yield is "relatively scarce" and that it is only disproportionate borrowing where they have concerns despite the fact that borrowing for yield at any scale is at odds with the Department's own guidance. However, the NAO's report shows that 179 authorities purchased commercial property in the three years to 2018–19. Activity was concentrated within this group, with 49 authorities (14%) accounting for 80% of spend, but this is nonetheless a sizeable group of authorities. Some 105 local authorities spent over £10 million on commercial property in the three years to 2018–19, compared to 13 authorities in the preceding three years. The NAO's report demonstrates the significance of acquiring property for yield rather than service provision: £2.5 billion of spend in the three years to 2018–19 was on property out of authorities' own areas with 64 authorities incurring this form of spend. The NAO's report identifies that up to £6 billion of spending on commercial property in the three years to 2018–19 was financed by borrowing. We recognise the prudential framework provides valuable borrowing and investment freedoms and understand the sector's determination to protect them and the Department's reluctance to intervene. Nonetheless, a balance has to be struck between protecting the framework and challenging behaviour that does not conform to its principles. **Recommendation:** ***The Department must be more active in its oversight of the prudential framework and strike a better balance between supporting localism and ensuring that local authorities act within the frameworks that underpin local freedoms. To do this the Department should:***

   - ***communicate publicly the types and scale of commercial activity, including new innovative types of commercial investment, where it has concerns that behaviour is not consistent with the spirit of the prudential framework;***
   - ***publicly challenge behaviour where it has concerns; and***
   - ***work with the LGA and other sector bodies to ensure that the Department's concerns are understood and communicated consistently across the sector.***

2. **The Department's failure to ensure that authorities adhere to the spirit of the framework has led to some authorities taking on extreme levels of debt which is**

both risky and sends a mixed message to the sector. Amongst the group of district councils that have been most active in acquiring commercial property the median level of external borrowing as a share of spending power (government grant plus council tax) increased from 3% to 756% from 2015–16 to 2018–19. By the end of 2018–19, Spelthorne Borough Council had borrowed £1.1 billion against annual core spending power of £11 million, a ratio of almost 100 to 1. This debt has to be serviced by rental income, and the current difficult economic conditions due to the COVID-19 pandemic demonstrate that these income streams cannot be taken for granted. Guidance from both the Department and CIPFA is clear that authorities should not borrow solely to invest for profit. In CIPFA's view this activity has traditionally been viewed as unlawful. Nonetheless, the prudential framework, even with the revised investment guidance, has failed to constrain the extreme levels of risk taking by some authorities. The behaviour of these authorities not only means that they are highly exposed to risk, but it also alters the terms of the debate; the outlier authorities are viewed as behaving poorly, while other authorities borrowing for yield at relatively lower levels are now not necessarily seen as an issue. Extreme behaviour needs to be curtailed not only for the risk it represents for those specific cases, but also for the mixed messages it sends across the sector, normalising behaviour that may be relatively less risky but nonetheless is still not within the spirit of the framework.

3. **Where a local authority uses prudential borrowing, it must set aside money each year to repay the debt.** This is known as Minimum Revenue Provision (MRP). It means that borrowing is reflected in current spending and the costs of borrowing do not fall wholly on future council tax payers. The Department's MRP guidance is clear that prudence requires making MRP in relation to debt associated with commercial property purchases. Local authorities must have regard to the Department's guidance but ultimately make their own decisions about prudent MRP. The NAO found some instances where local authorities were still not making MRP on their commercial property acquisitions. Richard Watts, Chair of the Local Government Association Resources Board told us that not applying MRP "strays very close to breaching" the requirements on authorities.

Recommendation: ***For its future oversight of the prudential framework the Department needs to develop, and rapidly deploy, interventions that target extreme risk taking. These should be used as part of a wider package of measures to limit non-compliance with the framework, regardless of scale.***

Recommendation: ***The Department should undertake a review of the MRP guidance and consider whether its statutory basis should be strengthened and how to require local authorities to improve the clarity and transparency in relation to commercial property purchases.***

4. **The actions taken by the Department to address risky and non-compliant behaviour have been too little and too late.** The Department has recently changed aspects of the investment guidance in response to rapid growth in spending on commercial property and in levels of borrowing. Work began on these changes following the publication of this Committee's November 2016 report, but the guidance changes were not operational until 2018–19. Even when they were operational, the Department was anticipating only gradual movement in the "right

direction". The NAO estimates that authorities spent £2.6 billion in 2017–18 when the guidance changes were being developed, and £2.2 billion in the first year of their operation, and a further £1bn in the first half of 2019–2020. When the pattern of public expenditure is changing at this speed, interventions need to be implemented more quickly and be operational from the outset. A framework that can only be revised at a significantly slower rate than the changes in the behaviour it is supposed to manage is not effective. The Department recognises that the guidance changes have not had the desired effect and have told us that "further action" is needed. HM Treasury is consulting on prohibiting loans purely for yield and investments outside an Authorities area. The consultation also proposes that authorities have to provide more detail, including on potential commercial investment, on their borrowing and investment activities in their annual returns to the Public Works Loan Board (PWLB). In October 2019 HM Treasury announced a one percentage point increase in the cost of new PWLB loans, which the NAO consider may influence some authorities' decisions on future commercial property acquisition. HM Treasury's decision to bring the PWLB back in house will also enable departments to access more accurate and timely information about loans.

5. **Taken together these changes represent a significant 'hard' intervention and demonstrate that the 'soft' approach of guidance changes has failed.** In order to support the framework going forward, and to help design future effective interventions and minimise the need for hard interventions, the Department needs to establish why its recent guidance changes have been insufficient.

Recommendation: ***The Department should take steps to ensure that future interventions are more timely and effective, and subject to rigorous post-implementation review to ensure lessons are learnt.***

6. **The prudential framework has been impaired by the emergence of new forms of behaviour in the sector, and now requires fundamental review.** The Department says that authorities have "managed, as it were, to escape" from the affordability constraint that is critical to the prudential framework. We are particularly concerned to hear that this undermines the Department's statutory backstop powers to intervene in relation to borrowing by individual councils. In addition, there are a range of innovative financial practices such as income strips and renewable energy schemes, including 'solar bonds', that the government needs to understand better. Written evidence and sector witnesses offered a range of explanations for the change of behaviour, including financial pressure on local services, government encouragement for commercial behaviour and a lack of clarity. These are not legitimate excuses for non-compliance and the Department recognises the need to tackle new behaviours.

Recommendation: ***Working with CIPFA and sector stakeholder bodies, the Department should undertake a thorough review of the prudential framework, that addresses the issues we have identified. The Department should publicly report within the next 12 months. This review should incorporate the recommendations relating to challenging behaviour in the sector, designing effective interventions and improving the data held by the Department set out elsewhere in this report.***

7. **The Department does not have access to the data it needs to carry out its oversight responsibilities properly.** In this Committee's 2016 report we recommended that the Department improve the data it holds on local authority commercial investment activity. The Department did take steps to improve the data it has access to, but these changes have not added much clarity, and the new data the Department acquired is already outdated. The Department needs to improve the data it has access to on local authority investment activity and the associated risks, so it can assess the exposure to risk of local government investment in individual sectors. It also needs better data to ensure framework compliance.

8. **We welcome the Department's statement that it will undertake a 'serious' data review in relation to local authority commercial investment.** It is important that the review considers data not only on commercial property acquisition, but on new forms of commercial activity such as investment in renewable energy schemes, the use of innovative financial arrangements such as income strips, and the use of arms-length trading companies. The review should also examine the extent to which data can be used to assess framework compliance, particularly in relation to borrowing for yield. Given the way authorities' capital programmes are financed, we recognise the complexities of identifying this activity definitively. But the Department should nonetheless look for possible measures to give some sense of the potential scale and direction of travel of this activity which can then trigger further investigation if required.

 Recommendation: ***The Department should write to the Committee by September 2020 setting out its approach and timescale for improving its data on council commercial activity, and how this relates to its broader review of the prudential framework. The Department should also set out how it intends to use its improved data following the data reviews to strengthen framework compliance. The data review should address the concerns we have raised relating to data on new forms of commercial activity, and on the use of data to assess framework compliance.***

9. **Changes to external audit might improve its ability to provide assurance related to local authority commercial investment activity but it will not be a silver bullet.** There are concerns in the sector about the capacity of local audit. The Department's Post Implementation Review of its recent guidance changes concluded that audit "should not be viewed as a strategy for mitigating risk within the system" as it is unlikely to inform decision making when authorities are developing their commercial strategies. The Department points to the Redmond review of external audit as covering issues relating to commercial investment; the Department will consider what changes should be made to the local audit framework once it has received the report of the Redmond review. We welcome the realistic view about the role of external audit presented by departmental witnesses: focusing on the assurance that audit provides about local governance and not seeing it as a substitute for scrutiny in real time. The Centre for Public Scrutiny emphasised that local governance needs to be bolstered rather than external bodies second-guessing council decision making, which risks muddying accountability. We anticipate that the outcome of the audit review will represent at best one aspect of the action that need to be taken

to address local governance issues in relation to commercial investment, and will therefore need to be accompanied by a broader package of measures beyond local audit improvements.

Recommendation: ***As part of its review of the prudential framework, the Department should consider a wider package of changes, rather than relying primarily on (post-Redmond) external audit to address failings in the local governance of commercial investment activities.***

Recommendation: ***The Department should write to the Committee within three months of the publication of the Redmond Review setting out its response to the review, including not only how the Department intends to strengthen local audit but also how this will support improved governance of commercial investment activity.***

10. **Local governance arrangements are not robust enough with some authorities' commercial investments not being properly transparent or subject to adequate scrutiny and challenge.** In May 2019 this Committee expressed concern about weak arrangements for the management of risk in local authorities' commercial investment. We have recently needed to make clear to central government that commercial sensitivity is not an adequate excuse for concealing risk and uncertainty. Accordingly, we were disturbed to receive written evidence as part of this inquiry which highlighted limited reporting to members, decision-making by very small groups, and a reliance on commercial sensitivity to excuse this kind of behaviour. The Centre for Public Scrutiny told us that, in some councils, member governance has not caught up with commercial activity and a change in culture is required. Some local capital strategies still do not contain the level of transparency encouraged by the Department.

Recommendation: ***The Department should:***

- ***work with LGA to disseminate good practice about transparent and inclusive decision making;***
- ***following discussion with the sector, set clear expectations about the details required in capital strategies not only about planned investments but also previous investments including their performance against expectations, financing costs, the scale of contingency reserves, and their contribution to service budgets; and***
- ***work with relevant partners to support local arrangements for scrutiny and challenge of council investments.***

1 Commercial property purchasing

1. On the basis of a report by the Comptroller and Auditor General, we took evidence from the Ministry of Housing, Communities & Local Government (the Department) and HM Treasury.[1] We also took evidence from witnesses representing the Local Government Association (LGA), the Chartered Institute of Public Finance and Accountancy (CIPFA), South Hams District Council and chartered surveyors working in the public sector.

2. Local authorities can acquire commercial property to support objectives such as regeneration and place-making. They can finance these activities by borrowing and are able to generate a commercial yield as a by-product of this investment. Authorities can also acquire commercial property primarily for yield, but this should be funded through capital receipts or revenue resources from their general fund. According to CIPFA, borrowing solely to invest for yield has traditionally presumed to be unlawful. The Department has responsibility for the framework of powers and duties, and a set of statutory codes and guidance within which local borrowing and investment decisions are made.[2]

3. In the context of a period of sustained funding reductions, some local authorities have adopted a new approach to the acquisition of commercial property. The scale of activity has increased with an estimated spend of £6.6 billion on commercial property in the three years to 2018–19; over 14 times more than in the preceding three years. Up to 91% of this spending was financed by borrowing, and the pursuit of yield to offset funding reductions was a predominant factor underlying these investments. Spending was concentrated in a minority of authorities; 49 councils (14%) accounted for 80% of the spend.[3] As with all investments, these acquisitions involve risk, particularly where they are financed by borrowing. Some authorities now have levels of external borrowing that are many multiples of their spending power (government funding and council tax). Much of this debt is long-term, and authorities are reliant on steady rental income to service the debt.[4]

Complacency

4. In this Committee's 2016 report we said the Department appeared complacent regarding the acquisition of commercial property by some authorities.[5] The Department did take some steps following the report to address authorities' behaviour, principally by revising the investment guidance for authorities. However, the Department told us that these changes have not had "all the effect" that was needed.[6] HM Treasury is now proposing to alter Public Works Loan Board (PWLB) lending terms to put an end to the 'borrowing for yield' model pursued by some authorities.[7]

5. A key factor underlying the Department's failure to manage this activity has been its continued complacency in relation to the true nature and scale of the issue. In its responses to us the Department referred to "a relatively small number", "a very small number",

1 C&AG's Report, *Local authority investment in commercial property*, Session 2019–20, HC 45, 13 February 2020
2 C&AG's Report, paras 1.2, 1.3, 1.13
3 C&AG's Report, paras 2.5, 2.10, 2.15–2.17, 3.3, Figure 3
4 C&AG's Report, Figures 15 and 19
5 HC Committee of Public Accounts, *Financial sustainability of local authorities*, Twenty-Sixth Report of Session 2016–17, HC 708, 18 November 2016, para 1
6 Q 103; C&AG's Report, para 4.15
7 Q 103; C&AG's Report, para 2.5 and Figure 3

and "a handful" of councils where they have concerns.[8] The Department also argues that investing solely for yield is "relatively scarce",[9] and that it is only disproportionate borrowing where they have concerns despite the fact that borrowing for yield at any scale is at odds with the Department's own guidance.[10] Some sector bodies made the same arguments in their evidence. The Local Government Association, for instance, argued in a variety of ways that borrowing for yield was minimal and that rules should not be set based on "a handful of small and quite extreme examples of council practice.".[11]

6. The evidence does not support this position. The NAO's report shows that 179 authorities purchased commercial property in the three years to 2018–19. Activity was concentrated within this group, with 49 authorities (14%) accounting for 80% of spend. But this is nonetheless a sizeable group of authorities. Some 105 local authorities spent over £10 million on commercial property in the three years to 2018–19, compared to 13 authorities in the preceding three years.[12] The NAO's report demonstrates the significance of acquiring property for yield rather than service provision: 38% (£2.5 billion) of spend in the three years to 2018–19 was on property out of authorities' own areas with 64 authorities incurring this form of spend; and authorities recorded spend of £4.1 billion across 2016–17 and 2017–18 in the Whole of Government Accounts on investment properties, which are held for rental income, capital appreciation or both.[13] The NAO's report identifies that up to £6 billion of spending on commercial property in the three years to 2018–19 was financed by borrowing. External borrowing levels for some authorities that have been most active in acquiring commercial property are now many multiples of their spending power.[14] We also received written evidence from a number from stakeholder bodies and authorities which were frank that they or some of their members were investing in commercial property, including out of area, in response to financial challenges since 2010–11.[15]

7. The Department was clear that it does not want to implement changes to the prudential framework which could potentially compromise local authorities' capacity and freedom to invest in activities such as regeneration.[16] In our view, it is this reticence to intervene in the system that has underpinned the Department's complacency regarding the scale of authorities' commercial property investment activities, its unwillingness to comment publicly or confront behaviour not in line with the spirit of the framework, and its inability to fulfil its responsibilities by designing interventions that are urgent and robust enough.[17] Ultimately, the Department's failure to balance its support for local freedoms against its responsibility to ensure that the prudential framework functions as intended has in fact resulted in the situation where significant intervention in the form of the proposed PWLB changes is now likely.

8 Qq 120, 130

9 Ministry of Housing, Communities and Local Government, *Post Implementation Review of Changes to the Local Authority Capital Finance Framework*, April 2020, para 4.4 (Hereafter, the Department's Post Implementation Review)

10 Q 130

11 Q 61

12 C&AG's Report, para 2.10

13 C&AG's Report, paras 2.17, 2.23 and 2.27

14 C&AG's Report, para 3.13, 3.30

15 LAI0018, LAI0023, LAI0027, LAI0033 and LAI0040

16 Q 143

17 C&AG's Report, para 4.17

8. We are not reassured that the Department is on the front foot in relation to the risks of new forms of commercial activity such investment in renewable energy or the use of innovative financial instruments. To hear from the Department only that these investments "might be caught in the grey area" relating to the proposed PWLB changes was alarming.[18]

Responding too late

9. The Department has stated that the changes proposed to the PWLB's lending terms will be a "game changer" and that they will "…ensure that the new behaviours we have seen in the past do not continue in the future".[19] While this sounds reassuring, it is taking place four years after the borrowing for yield model first began to spread across the sector and was brought to the Department's attention. Ultimately these proposals are four years and many billions of pounds in borrowing and potentially risky investments too late.

10. The NAO first highlighted the emergence of this activity in June 2016,[20] which was followed by this Committee's report in November 2016.[21] The Department began work in response to the report and issued new investment guidance which became operational on 1 April 2018.[22] The Department also worked with CIPFA on changes to CIPFA's codes.[23] However, even when the new guidance was operational the Department was anticipating only gradual movement in the "right direction". We recognise that introducing framework changes can be complex and time-consuming, but there has to be a quicker way of intervening when patterns of behaviour are changing so rapidly. In 2015–16 authorities spent £200 million on commercial property. In 2016–17, the year in which the NAO first highlighted this issue, authorities spent £1.8 billion, followed by £2.6 billion in 2017–18 and £2.2 billion in 2018–19.[24] When spending behaviour is changing so rapidly it is not acceptable to pursue intervention models that take over 12 months to implement, and then even at that point are not expected to deliver significant change.

11. The Department has conceded that the new guidance has not had the effect that was needed and that further changes are required.[25] This reflects the analysis in the NAO report which indicates that levels of spending on commercial property remained largely unchanged in the 18 months following the introduction of the new guidance.[26] HM Treasury, working with the Department, are now proposing significant changes to the PWLB's lending terms. These changes include the government asking local authorities to provide details annually of their borrowing and investment plans in order to access PWLB borrowing. The Department told us that these proposals will deliver significant

18 Q 114
19 Qq 120, 143
20 Comptroller and Auditor General, *Financial sustainability of local authorities: capital expenditure and resourcing*, Session 2016–17, HC 234, June 2016, para 2.26
21 HC Committee of Public Accounts, *Financial sustainability of local authorities*, Twenty-Sixth Report of Session 2016–17, HC 708, 18 November 2016
22 Ministry of Housing, Communities & Local Government, *Statutory Guidance on Local Government Investments*, 3rd edition, February 2018
23 Chartered Institute of Public Finance and Accountancy, *Prudential Code for Capital Finance in Local Authorities* and *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, both December 2017
24 C&AG's Report, para 4.21, Figure 3
25 Qq 103, 104
26 C&AG's report, para 2.5 and Figure 3

behaviour change in the sector.[27] However, in the context of the permissive nature of the prudential framework it has to be a matter of regret that the 'soft' approach of issuing new guidance has failed, and instead the Department and HM Treasury have had to resort to introducing new 'hard' parameters on authorities' behaviour. In order to support future interventions and limit the need for further 'hard' interventions the Department must establish why the guidance changes it introduced were not sufficiently effective. The Department has conducted a post-implementation review of the impact of its guidance changes. However the review does not reflect the evidence given to the committee by the Department that further change to the framework in the form of the PWLB changes is needed, nor in fact does it contain any reference to the proposed PWLB changes despite being published after HM Treasury had begun consulting on them. We assume a fuller review setting out why it was felt that the guidance had not succeeded and therefore that further action was necessary will be undertaken in the next phase of review work the Department told the NAO it will undertake.[28]

Extremely high debt levels

12. During the period of ineffective guidance, some authorities have taken on very high levels of debt, with accompanying risks. Amongst the group of district councils that have been most active in acquiring commercial property the median level of external debt as a share of spending power (government grant plus council tax) increased from 3% to 756% from 2015–16 to 2018–19.[29] By the end of 2018–19, Spelthorne Borough Council had borrowed £1.1 billion against annual core spending power of £11 million, a ratio of almost 100 to 1.[30]

13. The cost of servicing debt linked to commercial property investments is intended to be met from rental income or contingency reserves.[31] We have been sent worrying written evidence about the potential impact of the COVID-19 pandemic on such rental income. Spelthorne Borough Council, which has a debt-funded commercial property portfolio worth approximately £1 billion, said that COVID-19 "poses the most extreme economic stress test for more than two centuries."[32]

14. The Department told us "a very small number of councils that have borrowed disproportionately … is what we are most concerned about in the Department; it is the Spelthornes of this world." The Department went on to say, "We are not necessarily concerned about a council where they are undertaking a reasonable amount of commercial activity but their borrowing ratios look sensible and look proportionate with their income."[33] Some written evidence from within the sector argued that a measured approach to income generation through borrowing and commercial investment should be recognised as beneficial.[34] However, statutory guidance and codes from the Department and CIPFA are clear that borrowing to invest solely for yield is not in accordance with the

27 Qq 109, 136
28 C&AG's Report, para 4.21
29 C&AG's Report, Figure 15
30 Ministry for Housing, Communities & Local Government, *Core spending power: final local government finance settlement 2019 to 2020*, January 2019. Spelthorne Borough Council, *Capital Strategy 2020–25 – Appendix 5, Treasury Management*, February 2020
31 C&AG's Report, para 3.18
32 LAI002, LAI0019, LAI0033, LAI0035
33 Qq 130 and 131
34 LAI0018, LAI 0027

framework.[35] Knowsley Council's written evidence was clear that local authorities that have due regard to the principles and spirit of the framework "do not borrow purely to make a commercial yield".[36]

15. Where a local authority uses prudential borrowing, it must set aside money annually to repay the principal, so the costs do not fall wholly on future council tax payers. This is known as Minimum Revenue Provision (MRP). It is an important means by which the cost of borrowing is reflected in current spending. The Department told us it changed its MRP guidance to specify that MRP is needed for investment properties in order to address concerns about authorities not making prudent provision for commercial property.[37] Local authorities must have regard to the Department's guidance but ultimately make their own decisions about prudent MRP. The NAO found some instances where local authorities were still not making MRP on their commercial property acquisitions.[38] Richard Watts, Chair of the Local Government Association Resources Board told us that not applying MRP "strays very close to breaching" the requirements on authorities.[39]

A broken control framework

16. The prudential framework has been tested by new behaviours. These are not limited to the commercial property purchases and associated borrowing outlined above. Watford Council has acquired a 40-year lease on a local business park with an annual rent of £9.2 million (linked to RPI) along with the right to buy the property at the end of the lease for a nominal sum.[40] Local authorities have also established trading companies, entered into joint ventures with private developers, made loans to other bodies on a commercial basis, and invested in renewable energy.[41] Thurrock Council has borrowed to invest over £700 million in renewable energy through complex and indirect routes.[42] Unfortunately there is a history of authorities entering into commercial arrangements that provide initial benefits but subsequently cause widespread concern: use of Lender Option, Borrower Option (LOBO) loans is the most recent example.[43]

17. We were presented with a range of explanations for the change in behaviour. For example, the Local Government Association told us that activity has been driven by a need to offset lost income to protect local services and claimed the biggest thing government could do to alleviate this activity is to revisit local government funding.[44] Other written evidence made similar points.[45] The LGA also said that "Councils operating in an

35 C&AG's Report, para 4.19 and Figure 21
36 LAI0026
37 C&AG's Report, para 1.8 and Figure 21; Q 105
38 C&AG's Report para 4.27, and Figure 1
39 Q 38
40 C&AG's Report, paras 2.8 and 2.9
41 C&AG's Report, paras 28, 2.3
42 Jonathan Ford, Max Harlow and Gareth Davies, 'Revealed: an Essex council's £1bn borrowing spree to fund investment in solar power', *Financial Times*, 22 May 2020
43 A review of objections made to auditors by members of the public between 2015 and 2019 found that 24 of the objections accepted for consideration related to LOBO loans; the audit fees for dealing with these 24 objections were over £400,000. https://www.psaa.co.uk/wp-content/uploads/2020/04/PSAA-analysis-of-objections-final-for-website.pdf. See also Comptroller & Auditor General, *Financial sustainability of local authorities: capital expenditure and resourcing*, Session 2016–17, HC 234, June 2016, paras 1.48 to 1.51. For earlier examples of activities giving rise to concern, see HC Communities and Local Government Committee, *Local authority investments*, Seventh Report of Session 2008–09, HC 164-I, 11 June 2009; LAI0001 and LAI0032.
44 Q 48; LAI0020
45 For example, LAI0018, LAI0023, LAI0027, LAI0029

environment where Government Ministers encourage them to be "more commercial" have often done exactly that."[46] In written evidence, Mr Paul Brooks said that the legal position needs to be clarified while Arlingclose wrote that that official guidance is confusing and so it is understandable that some councils interpreted it as permitting such a wider range of property investment activity.[47] However, ultimately the arguments presented here do not change or remove the obligations imposed by the framework.

18. The Department rightly still wishes councils to abide by the spirit as well as the letter of the framework, with the Permanent Secretary telling us "I would very strongly expect every council to follow it".[48] Affordability no longer acts as a binding constraint on local authority borrowing in the way that it did when the framework was created.[49] Departmental officials advise Ministers about the use of reserve powers to cap borrowing by individual local authorities.[50] However, the Department has not felt able to use this power because authorities "have managed, as it were, to escape out of that affordability test" on which the power depends.[51] The government recognises the need to consider further changes to the prudential framework, including the need for a system that tackles the new behaviours of concern.[52] CIPFA has some specific proposals for changes to the framework, including making the prudential code more strongly binding on councils corporately; currently they only have to 'have regard' to it.[53]

46 Q 61
47 LAI0040, LAI0028
48 Qq 101, 109
49 Q 119; C&AG's Report, para 4.29
50 C&AG's Report, Figure 1
51 Q 120
52 Qq 112, 136, 143.
53 Q 35; C&AG's Report, para 1.9 and Figure 1

2 Oversight and intervention

19. The Department has overall responsibility for the effectiveness of the prudential framework. It takes assurance on the system's effectiveness from data provided by local authorities on their borrowing and investment activities, the work of external auditors, and the operation of a range of statutory roles and responsibilities designed to support good governance within local authorities.[54]

Shortcomings with data

20. In 2016 this Committee recommended that the Department review its data on capital expenditure and financing in the light of new behaviours in the sector. We stated specifically that the Department should ensure that the purpose and geographical location of capital spending can be ascertained from their data.[55] The Department did take steps to improve the data it collects and also acquired some proprietary data. However, the NAO concluded that the changes to Departmental data did "…not add much clarity", while the proprietary data it acquired appeared to "…understate the overall scale of the acquisition of commercial property by local authorities, particularly property acquired out of area". The NAO concluded that this data and the associated analysis undertaken by the Department were "outdated". The NAO also highlighted that the Department's data, "…do not demonstrate whether commercial property investments are delivering planned returns or how significant these returns are to local service provision". Finally, the NAO identified that the Department did not undertake analysis on the borrowing data it holds to make any assessment of the extent to which authorities may have been borrowing for yield.[56] We recognise that this cannot be determined categorically, but we would have expected the Department to have undertaken work to produce indicative figures at the very least.

21. The Department has effectively been flying blind over this period and it needs to get a grip on this in the future. The fact that the NAO had to purchase data in order to complete its review is evidence of a significant shortcoming by the Department.[57] We welcome the Department's recognition that it needs to improve the data it collects and its commitment to "…undertake a serious data review". However, we are concerned by the implication by the Department that the proposed changes to the PWLB will stop out-of-area investments and therefore make data on the location of investments less relevant.[58] This may be the case, but the Department's data review needs to be aimed at capturing data on emerging and future commercial investment activities rather than solely on current ones. In this respect we were not reassured that the Department has a sense of urgency in relation to acquiring data and properly understanding the new commercial strategies local authorities are now pursuing beyond the acquisition of commercial property.[59]

Realistic expectations of external audit

22. Local authority external auditors may examine issues relating to commercial property purchases or borrowing where they see these as a significant risk. Twice in the last two

54 C&AG's Report para 4.13
55 HC Committee of Public Accounts, *Financial sustainability of local authorities*, Twenty-Sixth Report of Session 2016–17, HC 708, 18 November 2016, recommendation 5, page 7
56 C&AG's Report, paras 4.4–4.6, 4.14
57 Qq 137, 143; C&AG's Report, p67
58 Qq 109, 137
59 Q 113

years, auditors have qualified their conclusions on a local authority's value for money arrangements due to concerns relating to commercial property acquisitions.[60] However, in a survey carried out for the local audit appointing body, almost 40% of finance directors and 30% of audit committee chairs were not able to agree that the audit service provided during 2019–20 met expectations.[61]

23. The Department's Post Implementation Review of Changes to the Local Authority Capital Finance Framework demonstrated that the direct role of external audit in relation to commercial property purchases is currently limited: audit work does not always examine capital investment and borrowing strategies, where it does the approach is 'light touch' and does not involve challenging the assumptions. In addition, there needs to be very clear evidence of risks or issues with a commercial property acquisition before the auditor would examine it, which would generally be after the investment had already been made. Accordingly audit "should not be viewed as a strategy for mitigating risk within the system".[62] In the Department's view, external audit cannot be relied on to prevent authorities from incurring excessive risk through commercial property acquisitions: it is not a substitute for scrutinising something that is happening in real time. The Department does however see external audit as providing assurance about council governance and transparency.[63]

24. The Department has commissioned Sir Tony Redmond to carry out an independent review of the operation of external audit arrangements, including the implications for audit of the growth in commercial investment activity. The Department will consider whether the external audit framework could deliver more specific assurance in relation to compliance with the prudential framework once that review has been received.[64] The Department told us that their aim is for the Redmond review to be completed in September 2020.[65] The Centre for Public Scrutiny argued against creating a situation where external bodies "begin to second-guess the decision-making of councils" as this could lead to diffuse, less effective accountability; instead the Centre recommended bolstering local governance.[66] External audit reforms are not the only game in town. This Committee previously recommended taking concrete actions to improve local governance and accountability more widely.[67] The Department will consider strengthening local authority audit committees and CIPFA has suggested further specific options such as ensuring that the statutory chief financial officer role is held by a suitably senior officer.[68]

Problems with local governance

25. The Department has said that transparency is important.[69] Good governance in local

60 C&AG's Report, Figure 1, para 3.35; Department's Post Implementation Review, para 5.12
61 Local Government Association, *PSAA Quality of Audit Service feedback survey*, December 2019, pages 2 and 35–37
62 The Department's Post Implementation Review, paras 5.11–5.13; C&AG's report, para 4.13
63 Qq 133–135; Department's Post Implementation Review, para 19
64 Ministry of Housing, Communities & Local Government, *Review of local authority financial reporting and external audit: terms of reference*, 10 July 2019; the Department's Post Implementation Review, paras 26 and 2.13
65 Q 142
66 LAI0011
67 HC Committee of Public Accounts, *Local Government Governance and Accountability*, Ninety-Seventh Report of Session 2017–19, HC 2077, 15 May 2019
68 Q 35; LAI0011; the Department's Post Implementation Review, para 26
69 Q 110. See also HC Committee of Public Accounts, *Local Government Governance and Accountability*, Ninety-Seventh Report of Session 2017–19, HC 2077, 15 May 2019, para 16.

authorities is critically important given the pressure local authorities are under.[70] The previous Committee commented on weak arrangements for the management of risk in local authorities' commercial investments in May 2019.[71] Shortfalls in transparency are not confined to local authorities: we recently concluded that commercial sensitivity was not an adequate excuse for a lack of transparency by civil servants about the risks to the High Speed 2 programme.[72]

26. There is clear evidence about governance problems relating to local authority commercial investments. Based on its recent research, the Centre for Public Scrutiny reported that "In some councils member governance has not caught up with commercial activity"; the need for culture change is the greatest challenge to effective and safe commercial activity.[73] CIPFA's Chief Executive expressed some concerns about Chief Financial Officers (Section 151 Officers) at a minority of councils feeling inhibited about speaking truth to power. He stressed it is important that the Section 151 Officer is a senior director and therefore can give proper but unwelcome advice about financial strategies dependent on commercial income. Alternatively the Section 151 Officer may fear that, if they give such advice, they may see their roles demoted.[74] External auditors have expressed a range of concerns, including insufficient reporting to members, limited internal challenge to decisions, over-reliance on external expertise, and limited capacity and skills.[75] Current practices can cause concern locally: we received a striking range of written evidence alleging apparent problems with governance or transparency of commercial investments. For example: decision-making by very small sub-sets of the ruling group; cabinet papers or other information supporting purchase decisions that contain limited analysis or are kept confidential well after the purchase has completed; poorly formulated objectives for purchases; not allowing potential purchases to be called in for scrutiny; and placing reliance on advisors with an apparent risk of a conflict of interest.[76]

27. The Department told us it had strengthened the prudential framework to support transparency by requiring publication of capital and investment strategies that should include details of the significant investments that authorities are making.[77] However, the Department's Post Implementation Review found that there is still significant progress to be made in terms of transparency and that good practice is not currently wide ranging.[78] The National Audit Office also found examples of information missing from strategies, including risk indicators and the scale of contingency arrangements.[79] The Department's Review also found examples of policies where deviations from statutory guidance were not presented transparently to members.[80]

70 HC Committee of Public Accounts, *Local Government Governance and Accountability*, Ninety-Seventh Report of Session 2017–19, HC 2077, 15 May 2019, p. 3.
71 HC Committee of Public Accounts, *Local Government Governance and Accountability*, Ninety-Seventh Report of Session 2017–19, HC 2077, 15 May 2019
72 HC Committee of Public Accounts, *High Speed 2: Spring 2020 update*, Third Report of Session 2019–21, HC 84, 17 May 2020
73 LAI0011
74 Qq 33–34
75 C&AG's Report, para 3.33
76 LAI0010, LAI0012, LAI0015, LAI0016, LAI0024, LAI0025, LAI0034, LAI0035
77 Q 110; C&AG's Report, Figure 21
78 The Department's Post Implementation Review, paras 1.10, 1.12
79 C&AG's Report, para 4.28
80 The Department's Post Implementation Review, para 3.25

Formal minutes

Monday 6 July 2020

Virtual meeting

Members present:

Meg Hillier, in the Chair

Gareth Bacon	Mr Richard Holden
Olivia Blake	Shabana Mahmood
Sir Geoffrey Clifton-Brown	Mr Gagan Mohindra
Dame Cheryl Gillan	Sarah Olney
Peter Grant	James Wild

Draft Report (*Local authority investment in commercial property*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 27 read and agreed to.

Summary agreed to.

Introduction agreed to.

Conclusions and recommendations agreed to.

Resolved, That the Report be the Eleventh of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 8 July at 10:00am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 11 May 2020

Rob Whiteman, Chief Executive, The Chartered Institute of Public Finance and Accountancy; **Judy Pearce**, Leader, South Hams District Council; **Paul Brooks**, Executive Head of Regeneration and Property, Rushmoor Borough Council; **Richard Watts**, Chair, Local Government Association Resources Board Q1–64

Friday 15 May 2020

Jeremy Pocklington, Permanent Secretary, Ministry of Housing, Communities and Local Government; **Catherine Frances**, Director General, Local Government Finance, Ministry of Housing, Communities and Local Government; **Alex Skinner**, Head of Local Government Finance, Ministry of Housing, Communities and Local Government; **Will Garton**, Director, Public Services, HM Treasury Q65–143

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

LAI numbers are generated by the evidence processing system and so may not be complete.

1 Anonymous 5 (LAI0042)

2 Arlingclose Limited (Mr Mark Horsfield, Director) (LAI0028)

3 The Bureau of Investigative Journalism (LAI0035)

4 Centre for Public Scrutiny (Mr Ed Hammond, Director, Campaigns and Research) (LAI0011)

5 The Chartered Institute of Public Finance and Accountancy (LAI0031)

6 Cheetham & Mortimer Chartered Surveyors (Mr Robert Millington, Partner - Investment. Registered Valuer) (LAI0015)

7 Cllr Nigel Murphy - Manchester City Council (LAI0038)

8 Cllr Richard Watts (LAI0044)

9 Colchester Borough Council (LAI0030)

10 Cook, Mr Peter (LAI0025)

11 County Councils Network (LAI0013)

12 Dishman, Mr Derek (LAI0009)

13 District Councils' Network (Mrs Victoria Eade, Policy Officer) (LAI0027)

14 EG (Mr James Child, Head of Research) (LAI0004)

15 Essex County Council (LAI0041)

16 Huseynov, Mr. Tural (LAI0043)

17 ICAEW (Alison Ring, Director, Public Sector) (LAI0020)

18 Its Our Spelthorne (Martin Shortland, Founder) (LAI0016)

19 The Local Authorities' Mutual Investment Trust/CCLA (Cllr Richard Kemp, Cllr Richard Kemp CBE, Chairman, The Local Authorities Mutual Investment Trust) (LAI0007)

20 Local Government Association (Mr Iredia Oboh, Public Affairs and Campaigns Adviser) (LAI0021)

21 London Councils (Peter O'Connell, Policy Manager (Local Government Finance)) (LAI0022)

22 Mylvaganam, Mr Sashi (LAI0010)

23 Nichols, Mr Lawrence (LAI0012)

24 Reducing the Deficit Ltd (Mr David Lewis, Director) (LAI0029)

25 Rushmoor Council (LAI0040)

26 The Shepwayvox Team (Mr Bryan Rylands, Lead Blogger & Citizen Journalist) (LAI0032)

27 Simpson, Mr Peter (LAI0010)

28 Social Investment Business (Mr Will Thomson, Policy Lead) (LAI0019)

29 Society of District Council Treasurers (Mr Adrian Rowbotham, Lead Advisor for Growth and the Commercial Agenda) (LAI0018)

30 South Hams District Council (Mrs Lisa Buckle, Corporate Director for Strategic Finance) (LAI0017)

31 South Somerset District Council (Mr Robert Orrett, Commercial Property, Land and Development Manager) (LAI0023)

32 Spelthorne borough Council (LAI0033)

33 Tendering District Council (LAI0037)

34 Woking Borough Council (LAI0036)

35 Woking Labour (Dr Gerry Mitchell, Secretary) (LAI0024)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2019–21

First Report	Support for children with special educational needs and disabilities	HC 85
Second Report	Defence Nuclear Infrastructure	HC 86
Third Report	High Speed 2: Spring 2020 Update	HC 84
Fourth Report	EU Exit: Get ready for Brexit Campaign	HC 131
Fifth Report	University Technical Colleges	HC 87
Sixth Report	Excess votes 2018–19	HC 243
Seventh Report	Gambling regulation: problem gambling and protecting vulnerable people	HC 134
Eighth Report	NHS expenditure and financial management	HC 344
Ninth Report	Water supply and demand	HC 378
Tenth Report	Defence Capability and the Equipment Plan 2019-29	HC 247