



BRIEFING PAPER

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Local government: commercial property investments

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Summary

In the mid-2010s, some local authorities have sought to build up new portfolios of property in order, amongst other aims, to generate a profit from commercial lettings in order to increase their revenue budgets. This has taken place in the context of substantial falls in central government grants to English local authorities since 2010.

Many local authorities in the UK have long had sizeable property holdings and have been free to invest in property for purposes relating to their statutory duties and responsibilities. They may buy land and property both inside and outside their own areas. They are currently able to borrow money from the Public Works Loan Board (PWLB), or from other sources, at relatively low interest rates in order to invest in properties. Where the rental income from the properties exceeds the regular repayments on the loan, the authority may keep the difference and spend it on local services.

Borrowing and investment are matters of local government capital finance. Thus practice in this area is governed by CIPFA's Prudential Code for local authority finance. In addition, local authorities must take account of CIPFA's treasury management guidance for local authority funds, and the DCLG's statutory guidance on local authority investments and on minimum revenue provisions (MRP). CIPFA is reviewing the Prudential Code during 2017; and the DCLG launched a consultation on updating its two sets of statutory guidance in November 2017.

This briefing paper sets out the process and the legal background for local authority commercial property investment, notes recent media commentary, and presents some reported examples of large-scale commercial property activity. It notes some of the potential risks of this activity. It also notes some of the commentary, both positive and negative, on these initiatives from the sector and other actors. It also includes some details of previous episodes of local government financial innovations that are often quoted as 'cautionary tales' in the current context. These are the Hammersmith 'interest rate swaps' episode in the late 1980s; local authority investments in Icelandic banks in the late 2000s; and recent controversy over lender option, borrower option (LOBO) loans.

Commercial property acquisition has been most marked amongst English local authorities, though local authorities in Scotland, Wales and Northern Ireland also have general powers to acquire and manage property. The bulk of the briefing paper therefore covers developments in England only. Details on the position in Scotland, Wales and Northern Ireland can be found in section 5.

Additional information on local authority borrowing and capital finance management can be found in the Library briefing paper [Local government in England: capital finance](#).

1. Local authorities and commercial property

In 2016-17, a number of media reports claimed that local authorities had recently expanded their ownership of commercial assets, with the sole aim of generating income. The type of activities reported on have a long history in local government: they have not suddenly appeared in recent years.

The statutory basis for local government commercial property strategies differs between England, Scotland, Wales and Northern Ireland. This section concerns commercial property purchases in England (see section 5 for Scotland, Wales and Northern Ireland). Commercial property acquisition has been most marked amongst English local authorities, though local authorities in Scotland, Wales and Northern Ireland also have general powers to acquire and manage property.

1.1 Drivers for increased commercial activity

Two main developments have led to an increased interest in commercial property investments by English local authorities in the 2010s.

First, local approaches to asset management have changed. Research suggests that, during the 2010s, local authorities have shifted towards using assets as sources of ongoing revenue and away from disposing surplus land and buildings for housing or other use.¹ This has been complemented by greater pan-public sector co-operation over asset disposal, sharing, and usage. This is visible in the Government's One Public Estate programme and the creation of 'Land Commissions' in many devolution deals.²

Second, local authorities have experienced substantial reductions in central government funding since 2010. The Institute for Fiscal Studies claimed that grants to local authorities were cut by 36% between 2009-10 and 2014-15.³ The National Audit Office arrived at a similar projected figure for 2010-11 to 2015-16.⁴ Revenue Support Grant (RSG) funding is projected to be cut further, from £11.5 billion in 2015-16 to £5.4 billion in 2019-20.⁵ The Centre for Cities stated in 2017:

Between 2009/10 and 2016/17, excluding grants for education, police and fire services, English council revenues fell by 26 per cent, from £59 billion to £44 billion in today's prices. This squeeze

¹ See, for instance, Louise McGough and Hugh Bessis, *Delivering change: Making the most of public assets*, Centre for Cities, 2015; Alex Thomson and Peter Wilkes, *Public land, public good*, Localis, 2014

² See the Library briefing papers *Assets of community value* and *Devolution to local government in England* on these points.

³ David Innes and Gemma Tetlow, *Central cuts, local decision-making: changes in local government spending and revenues in England, 2009-10 to 2014-15*, Institute for Fiscal Studies, 2015

⁴ NAO, *Financial sustainability of local authorities*, 2014

⁵ HM Treasury, *Spending Review and Autumn Statement 2015*, Cm 9162, November 2015, p.100. These figures include funding for fire and rescue authorities. The IFS and NAO figures cited here do not include fire and rescue authorities or Police and Crime Commissioners.

on funding from central government is set to continue. Driven by increasing social care costs, if they remain constant, local government faces a £5.8 billion funding gap by 2020.⁶

These reductions provide a direct incentive for authorities to seek alternative sources of funding. Local authorities have greater freedom around, and may be able to obtain more money from, commercial activities than from 'traditional' sources of revenue such as council tax, business rates, and local fees and charges. Rob Whiteman, chief executive of CIPFA, said in 2017:

In fairness to councils, this increased focus on entrepreneurship has been a means of mitigating the loss of government grant, which has seen their spending cut by as much as 40% since 2010. Services are under tremendous stress, particularly from the provision of social care, and so without the returns being made from their new investment portfolios, service reductions would have been even higher.⁷

Government policies such as the Business Rates Retention Scheme and New Homes Bonus offer additional financial incentives for local development. If a property investment were to generate multiple income streams, this could potentially strengthen a council's business case compared to that of a private developer.

1.2 Commercial property strategies

Most authorities developing property portfolios do so using specific statutory powers, as they are regarded as 'incidental to' broader social and/or economic initiatives. This approach avoids the provision in section 4 of the *Localism Act 2011*, which requires that anything done for a purely commercial purpose must be done via a limited company. For instance, an authority might buy and regenerate a local shopping centre and thus contribute to employment, amenities, and economic growth.

There is a simple attraction to investing in commercial property. Local authorities can borrow funds from the Public Works Loan Board (PWL), though other sources could be used – for instance, capital receipts or 'internal borrowing'. PWL loans are available at 'sovereign rates', at present typically around 2-2.5%.⁸ By contrast, annual return rates on commercial property may be in the region of 5-10%. The spread between the loan rate and the return rate on letting out the property governs the profit made by the local authority.

An investigation by the *Local Government Chronicle* in October 2017 found that a third of the 265 responding councils had invested in property since 2010, with one-half of these being district councils from the South-East. Of the 265 councils, ten accounted for 60% of the expenditure reported in the responses. This suggests that only a small

⁶ Simon Jeffrey, [Delivering change: how city partnerships make the most of public assets](#), Centre for Cities, 2017

⁷ Rob Whiteman, "[Councils, commercialisation, and flexible borrowing](#)", CIPFA blog, 9 March 2017.

⁸ See the Library briefing paper [Local government in England: capital finance](#) for further details on the requirements governing local authority borrowing.

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number of councils are currently seeking to develop property portfolios at scale.

It should be noted that local authorities are free to purchase land or property outside of their own area. This means that a local authority covering a low-growth or economically weaker area can make profitable investments elsewhere. The *Local Government Chronicle's* investigation revealed that 37% of the 94 councils providing details of investments owned property outside their own area.

1.3 Legal foundations

Section 111 of the *Local Government Act 1972* gave local authorities the power to do anything “which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions”. When using this power, a local authority would need to identify which of their functions an activity was ‘incidental’ to.⁹ Thus it was not possible for local authorities to do something *solely* for a commercial purpose.

This situation was relaxed in the *Local Government Act 2003*, which permitted local authorities to pursue certain forms of commercial activity through a company structure. This was subject to statutory [guidance for the use of trading powers](#). The General Power of Competence, introduced by the [Localism Act 2011](#), permits a local authority exercising the general power:

- ... to do it in any way whatever, including—
- (a) power to do it anywhere in the United Kingdom or elsewhere,
- (b) power to do it for a commercial purpose or otherwise for a charge, or without charge, and
- (c) power to do it for, or otherwise than for, the benefit of the authority, its area or persons resident or present in its area.¹⁰

This would mean that a local authority would have to set up a company to manage property purely for financial gain. But as mentioned, most authorities hold and manage commercial property as an adjunct to other functions.

The Local Government Association published a guidance document entitled *Enterprising Councils* in mid-2017. This document focused on trading activity in general, not just property investment, but it includes the following recommendation:

This is a particularly specialist activity where advice should be sought, if necessary, from a range of experts such as lawyers, property experts and accountants. Councils considering investment activity should be clear around long term risk and benefit modelling, governance and what specialist capabilities may be required to support the activity. They should be aware of

⁹ Case law had limited the degree to which functions could be justified on the basis that they were incidental to activities that were themselves incidental to local authorities’ functions: see [McCarthy & Stone \(Developments\) Ltd. v Richmond upon Thames LBC \[1992\] 2 AC 48](#)

¹⁰ See the Library briefing [Local authorities: the general power of competence](#) for more details on the general power.

the accumulated effect of every decision they take as well as the risks of each individual decision.¹¹

1.4 Strategic risks

The key identifiable risks of a commercial property-based revenue strategy include:

- A downturn in the property market. This could lead to falling rents or higher vacancies, potentially meaning that authorities will need to cover their borrowing costs from other funds. It could also lead to a fall in property values: thus if a council wanted to repay the loan to avoid losing money, selling the asset would not produce enough money to do so (in effect, negative equity).¹² In either case the authority would face financial pressures;
- Government intervention, of an unspecified kind, to set limits on the commercialisation strategies available to local authorities. Mike Britch, group managing director of NPS Group (a wholly owned company of Norfolk County Council) raised this prospect at the LGA conference in July 2017:

“I have got a feeling it is going to end in tears at some point. I think it can get out of hand quite quickly and I am not convinced that some of the decision making has been taken with the best advice possible.

“I am supportive of a local authority doing it in their own area for economic regeneration purposes, but when they start getting into the commercial market I think the complaints are going to start coming from the commercial sector about distorting the market and I think the government will step in eventually and stop it.”¹³

The Government launched [a consultation in November 2017](#) proposing to introduce additional requirements into the statutory guidance for local authority treasury management (see section 2.3 below). [A report in early November 2017](#) had suggested that the Chancellor planned to introduce new rules on local authorities investing outside their geographical area in the November 2017 budget.

- Lack of expertise in council staff teams, leading to poor acquisition decisions. Some authorities have made use of external consultants, whilst others have increasingly developed in-house teams. The Centre for Cities notes that awareness of the market and the location of the investment within it are critical:

While many local authorities have experience in commercial services and feel comfortable with the risks associated with this, for those that do not, are moving into a new market or scaling up significantly, having a clear commercial mindset that is shared and

¹¹ LGA, [Enterprising councils: supporting councils' income generation activity](#), 2017, p36

¹² See, for instance, Nick Golding, “[Ministers prevent council homes but stand by as councils risk their futures on property](#)”, *Local Government Chronicle*, 26 October 2017. This article raises the possibility that town centres face a long-term decrease in values due to changing retail habits.

¹³ Colin Marrs, [Expert predicts central government could intervene to stop commercial property investment](#), Room 151, 13 July 2017. This text is entirely a quote of Mr Britch speaking at the CIPFA annual conference.

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understood at all levels of the local authority, is vital. There must be a clear focus on the gap in the market that they are looking to fill, who competitors will be, and the potential for and scale of risk.¹⁴

¹⁴ Simon Jeffrey, [Delivering change: How city partnerships make the most of public assets](#), Centre for Cities, 2017 p.18

2. Commentary on commercial property strategies

2.1 Press coverage: 2017

During mid-2017, there was a run of press coverage, most of which was cautionary about or critical of local authorities using loans to facilitate commercial property revenue.¹⁵

In early 2017, *The Times* used Freedom of Information requests to obtain information on recent commercial property deals carried out by councils. In an article published in April 2017, the newspaper reported concerns from investment experts about the long-term health of such activities. Concerns fell into two categories: the consequences of a downturn in the property market, and the costs of asset depreciation.

Sam Resouly, a partner at the investment firm Trinova Real Estate, said the trend had caused “distortion” in the market, with the PWLB giving councils an advantage over other bidders. He added: “If they buy 10 years’ income, they have to accept that as 10 years goes to zero, they’re going to get a rapid deterioration in the value of that asset. At some point they’re going to have to spend money to get it up to standard, and what happens to councils’ accounts then?”¹⁶

The research analysed 76 property transactions which took place in 2016, of which 58 took place within the relevant authority’s own area and 18 did not. They also reported allegations that local authorities have been bidding above market rates for certain buildings:

... market participants report that councils have been overpaying, amplifying the risks to them – and their local residents – of a future bust.¹⁷

2.2 Support for commercial property strategies

Some reports and commentary suggest that commercial property strategies are a manageable risk for councils, provided that they do not dominate councils’ financial activities and that prudent decisions are made. Though the drivers toward commercial activity have strengthened in recent years (see section 1.1), local authorities have long had large property holdings, which were used for a mixture of economic, social and commercial purposes. An Audit Commission report from 2000 states:

Councils in England and Wales have a portfolio of assets that is valued in excess of £140 billion, or £78 billion excluding council housing... Typical non-operational properties include high street retail outlets, markets, industrial estates and shops on housing

¹⁵ See, for instance, [FT View: local councils are set to lose the property game](#), 26 April 2017; Ian King, [“Revolution in council lending could tackle irresponsible borrowing”](#), *The Times*, 13 April 2017; John Plender, [“UK public finance: councils build a credit bubble”](#), *Financial Times*, 25 April 2015

¹⁶ Oliver Shah, [“The great town hall property buying spree”](#), *The Times*, 9 April 2017

¹⁷ Oliver Shah, [“The great town hall property buying spree”](#), *The Times*, 9 April 2017

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estates, held primarily to generate income or to stimulate economic or social development..

...

Excluding housing, the average authority devotes 8 per cent of its annual revenue budget to running and maintaining its estate it is estimated that authorities in England and Wales spend at least £5 billion per year on property – more than their total expenditure on social services for the elderly.¹⁸

The trade journal *Euromoney* reported cautious support from within the investment world in April 2017:

"This is a logical thing for local authorities to do," Tony Martin, head of investment advisory capital advisors – investment advisory at CBRE, tells *Euromoney*. "Changes in local authority financing mean that they are challenged to cut costs and find new ways of producing income. A lot of councils are doing this now, and the number will rise. This is something that we should keep an eye on as the increase in activity has been significant over the last couple of years and how it will influence the market isn't always immediately obvious."¹⁹

Andrew Burns, chief finance officer of Staffordshire County Council and president of CIPFA, stated in July 2017:

Private sector investors are unhappy being outbid for sites; some argue that borrowing the full purchase price of property in markets they don't understand for short-term income gain is an "accident waiting to happen"

Providing councils are following the rules that dictate making sound and affordable investment decisions, using specialist internal and external advisers to identify and mitigate any investment risks, these activities bring benefits for councils and taxpayers.²⁰

Alison Griffin, finance director at the London Borough of Bexley, expressed similar views in January 2017:

...given the context and future outlook, can we really afford not to build on our history and be more commercial in our approaches and activity? ... this is core council business and has been for years. It's the context and emphasis that has changed. Where I do get worried is when there is an over-reliance on any single income or development scheme as the answer to a council's financial challenge.²¹

2.3 Regulatory frameworks

Regulatory frameworks do not set fixed limits on how local authorities may use capital funding, either in statute or guidance. However, a number of elements of good financial practice will influence authorities' behaviour. These include:

¹⁸ Audit Commission, *Hot property: making the most of local government assets*, 2000, p.5-7

¹⁹ Louise Bowman, "[Disquiet at UK local authorities' growing real estate exposure](#)", *Euromoney*, 11 Jul 2017

²⁰ Andrew Burns, [CIPFA president's blog: Commercial risk needs commercial capabilities, enhanced governance and transparency](#), Room 151, 17 July 2017

²¹ Alison Griffin, "[Can we afford not to be more commercial?](#)", *Room 151*, 9 January 2017

- Treasury management guidance, concerning the investment of local authority funds and cash holdings. In 2011 CIPFA (the Chartered Institute of Public Finance and Accountancy) published a guidance manual entitled [Treasury Management in the Public Services](#), which applies to local authorities and other public bodies;
- The *Prudential Code*. Published by CIPFA, this document contains guidance on the management of local authorities' capital finance, in particular the setting of borrowing limits. The Code states:

In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it / estimated for the future, together with the totality of its capital plans, revenue income and revenue expenditure forecasts for the forthcoming year and the following two years.²²

Local authorities must 'have regard' to the Prudential Code when managing capital finance.²³ CIPFA has undertaken a review of the Prudential Code during 2017 (not yet complete at the time of writing). The consultation paper said:

Increasingly local authorities are focusing on commercials, including increasing the number of services which are commissioned, maximising the commercial value of contracts and developing local markets.

This new approach brings the need to consider new and different risks for local authorities. It is essential that such risks are managed in an open and transparent way and views are sought on how the prudential code can be strengthened to encompass these risks.²⁴

- The local audit regime (see the Library briefing paper [Local audit in England](#)). This includes a requirement for annual audit of local authority accounts, and powers for auditors to produce Public Interest Reports and to apply to a court to declare expenditure unlawful if necessary;
- Local authority chief finance officers are required to issue a special report (a 'section 114 report') if it appears that their authority cannot set a balanced budget.

In addition, the Government holds powers to take over control of any local authority functions if the Secretary of State believes that the authority is not meeting 'best value' requirements.²⁵

Treasury management guidance

The use of capital funds for commercial property portfolios constitutes an investment by the local authority. However, until 2018 commercial property was not included in the definitions of 'investments' in either the Treasury Management Code or the DCLG's statutory investment

²² CIPFA, *The Prudential Code*, 2003, p.15

²³ See section 3 of the *Local Government Act 2003* and the [Local Authorities \(Capital Finance and Accounting\) \(England\) Regulations 2003](#) (SI 2003/3146).

²⁴ Colin Marrs, "[Commercialisation drives review of Prudential Code](#)", *Room 151*, 16 March 2017

²⁵ See section 15 of the [Local Government Act 1999](#).

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guidance. This has now changed (see below). The 2010 investment guidance stated:

The [investment] Strategy should set out the authority's policies for the prudent management of its investments and for giving priority, firstly, to the security of those investments and, secondly, to their liquidity. It should therefore identify the procedures for monitoring, assessing and mitigating the risk of loss of invested sums and for ensuring that such sums are readily accessible for expenditure whenever needed.²⁶

This reiterated that security – avoiding losses – and liquidity – ease of access – should take priority over achieving high commercial rates of return. The note published alongside the formal guidance states:

The generation of investment income is distinct from these prudential objectives and is accordingly not a matter for the guidance. However, that does not mean that authorities are recommended to ignore such potential revenues. Once proper levels of security and liquidity are determined, it will then be reasonable to consider what **yield** can be obtained consistent with those priorities.²⁷

The issue of liquidity is particularly important with respect to commercial property investment. If a local authority needed to meet immediate cash requirements, a shopping centre cannot be quickly realised in the same way that, for instance, bonds or some other financial instruments could be.

Revision of statutory investment guidance

The Government launched [a consultation on 16 November 2017](#) proposing revisions to the statutory guidance on local authority investments and on minimum revenue provision (MRP). New editions of the [statutory guidance on local government investments](#) and the [statutory guidance on minimum revenue provision](#) were published on 2 February 2018, alongside a [Government response to consultation](#).

The updated guidance on local government investments contains a number of provisions requiring local authorities to have a transparent financial strategy:

- Investments are defined as “all of the financial assets of a local authority as well as other non-financial assets that the organisation holds primarily or partially to generate a profit: for example, investment property portfolios”.²⁸ This explicitly defines commercial property as ‘investment’;
- Local authorities must prepare an investment strategy annually (or include the required details in their treasury management strategy). They must explain how their investments (including commercial property portfolios) relate to their core purposes;
- The investment strategy should also include “quantitative indicators that allow councillors and the public to assess a local

²⁶ DCLG, [Guidance on Local Authority Investments](#), 2010, paragraph 4.2, p.7. See also Communities and Local Government Committee,

²⁷ *Ibid.*, p.3

²⁸ MHCLG, [Statutory Guidance on Local Government Investments: 3rd edition](#), 2018, p1

authority's total risk exposure as a result of its investment decisions".²⁹ These indicators "should be presented in a way that allows elected member and the general public to understand... total risk exposure...";³⁰

- The investment strategy should set out the local authority's approach to risk assessment, including how it has assessed the market, what use has been made of external advisors and why, how credit ratings agencies have been used, and what other sources of information have been used;³¹
- The guidance requires an explicit statement of the degree to which commercial income underpins the delivery of services.³² The commentary published alongside the statutory guidance states that each local authority must set annual limits for the proportion of gross debt compared to net service expenditure, and the percentage of net service expenditure that comes from commercial income. This would indicate to what extent commercial income was underpinning an authority's ability to set a balanced budget.
- Local authorities will not be required to prioritise security and liquidity when managing non-financial assets:

In recognition that non-financial investments are, by their nature illiquid, and that local authorities may choose to hold onto investments for a number of years, particularly where they are held to contribute to local regeneration objectives, the Investment Guidance is now explicit that local authorities can determine the relative importance of security, liquidity and yield for different types of investment and can assess liquidity of non-financial assets on a portfolio basis.³³

Borrowing in advance of need

The commentary alongside the new guidance states that commercial property investment purely for profit is to be regarded as 'borrowing in advance of need', and that this does not constitute prudential borrowing. The language in the Government's response to consultation stops short of an outright ban.³⁴ However, where a local authority has borrowed money purely for commercial purposes, their investment strategy should explain why the statutory guidance has been disregarded, what use will be made of the money, and what procedures are in place if expected investment yield does not materialise.³⁵

This provision could make purchasing commercial properties outside a local authority's own area more challenging. Local authorities that invest in commercial property in their own areas frequently do so as part of their wider objectives: for instance, regeneration or community

²⁹ Ibid.

³⁰ Ibid., p4

³¹ Ibid., p7

³² Ibid.

³³ MCHLG, [Consultation on the proposed changes to the prudential framework of capital finance: summary of consultation responses and Government response](#), 2 February 2018, p9; see also Colin Marrs, "[Government eases reporting burden of revised investment code](#)", *Room 151*, 15 February 2018

³⁴ Ibid., p11

³⁵ Ibid., p8

development. In such cases, future profits from commercial investment can be argued to be a by-product of a broader strategy, not a form of borrowing in advance of need. This case is much less easy to make with commercial property outside an authority's area, as that would not relate directly to the authority's wider objectives.

The financial journalist Colin Marrs has argued that it will not be clear whether the new guidance amounts to a ban on this type of borrowing until a body of case law has developed.³⁶

2.4 The Government's position

There have been recent indications from the Government that generating revenue via increased commercial activity is regarded as an appropriate part of a mix of revenue sources from local government. In a debate on local government in the House of Lords in July 2017, Lord Young of Cookham, for the Government, stated that the Government was monitoring local authority commercial activity and ensuring that the governance framework was kept up to date.³⁷ The November consultation included a Government preference to clarify the uses made of commercial income:

The Government is concerned that some local authorities may become overly dependent on commercial income as a source of revenue for delivering statutory services. Given the nature of assets that local authorities are investing in this could leave them exposed to macro-economic trends. For example a decline in retail rental yield may leave a local authority that is highly dependent on retail rental income to deliver core services with a structural funding deficit.

For this reason the Government proposes requiring local authorities to disclose their dependence on commercial income to deliver statutory services and the amount of borrowing that has been committed to generate that income.³⁸

At a Public Accounts Committee hearing on 10 October 2016, Melanie Dawes, permanent secretary of the Department for Communities and Local Government, was questioned extensively on this point. She said:

...a lot of the time, the commercial structures that local authorities are putting in place are new ways of operating existing services. They are not necessarily more risky; they are actually just more professional, and one could argue that they are therefore less risky because they are finally recognising the game that local authorities have been in for quite some time.³⁹

Richard Bacon MP asked:

Is that not the whole idea of that Act: that local authorities can be more enterprising and more forward-thinking, knowing that

³⁶ See Colin Marrs, "[The property investment puzzle: 'Abuse', codes and case law](#)", *Room 151*, 10 January 2018

³⁷ [HCDeb 13 Jul 2017 c1374](#)

³⁸ DCLG, [Consultation on the proposed changes to the prudential framework of capital finance](#), November 2017, p10

³⁹ Public Accounts Committee, [Oral evidence: the financial sustainability of local government](#), HC 708, 10 Oct 2016, Q9

they're not going to get caught out for being ultra vires [acting outside their powers]?

Melanie Dawes: Indeed, it is, yes. That is the Localism Act and that was the intent, I believe.⁴⁰

...

Do we want them [local authorities] to become more entrepreneurial? Yes. Do we want them to become more independent? Yes. ... A degree of entrepreneurialism is part of the picture, yes, within the context of a prudential framework.⁴¹

The Government has no legal obligation to offer financial assistance to local authorities that get into financial difficulty. DCLG officials stated that they did not expect to do this if commercial activity caused financial problems for councils. This would reflect previous practice:

The point worth noting from a number of historical examples is that central government has steadfastly refused to bail out local authorities embroiled in difficulty. They have expected authorities to take their own legal and commercial advice and to manage their risks.⁴²

The officials stated that their assurance of effective local authority financial management came from the web of legal requirements noted in section 2.3: the prudential borrowing framework, audit requirements, and the obligation to set a sustainable budget. They also claimed that regular conversations and intelligence-gathering, via the Local Government Association and directly with councils, assisted them in maintaining an overview of the sector:

Melanie Dawes: We do monitor overall trends in the sector. We look in particular at a broad set of financial indicators for local authorities, and then we complement that with information about different service pressures—things like Ofsted reports, CQC inspections and so on... What that gives us is a sense of an overview for each local authority. Then we complement that with the intelligence and analysis we get by speaking to local authorities and being out there with the sector, and doing that with the LGA. We think we have a pretty good network of information.⁴³

The Public Accounts Committee produced a report after this hearing, in late 2016, which claimed that DCLG's tracking of all forms of capital spending by local authorities was weak:

The Department lacks a cumulative picture of capital risks and pressures across the sector.... [it] does not use the data it collects effectively to build its own system-wide picture of trends across the sector and carries out limited analysis related to capital. The Department's current understanding of risks across the sector, such as the deteriorating condition of capital assets, is not sufficient.⁴⁴

⁴⁰ Ibid., Q12

⁴¹ Ibid., Q16

⁴² Richard Harbord, "[Commercialisation brings its own risks](#)", *Room 151*, 24 April 2017

⁴³ Public Accounts Committee, [Oral evidence: the financial sustainability of local government](#), HC 708, 10 Oct 2016, Q28

⁴⁴ Public Accounts Committee, [Financial sustainability of local authorities](#), HC 708, 18 November 2016, p.6

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In the same report, the Public Accounts Committee accused the DCLG of 'complacency':

We are concerned that the Department for Communities and Local Government (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 property developers and commercial landlords with the primary aim of generating income. ...The Department does not have a good understanding of the scale and nature of these activities. It suggests that they are predominantly an extension of long-standing council activities and not necessarily more risky. However new and additional risks come from authorities purchasing properties to lease to businesses or developing houses for market rent, as authorities themselves recognise. Some authorities are also adopting these strategies in order to provide significant elements of their future revenue income. We do not share the Department's confidence that the increased commercial activity in the sector adds no particular risk to the Department's own work.⁴⁵

⁴⁵ Public Accounts Committee, [*Financial sustainability of local authorities*](#), 26th report 2016-17, HC-708, 18 Nov 2016, p. 5

3. Commercial property activity

3.1 Examples of commercial investments

A number of examples of local authorities developing commercial property portfolios have been reported in the press, with the associated costs. Some of these are reproduced here. It is not possible to confirm exactly the figures quoted:

- Spelthorne Borough Council bought BP's head office in Sunbury-on-Thames, for a sum reported variously as £360 million and £380 million.⁴⁶ This is by some way the largest deal that has been widely reported, both in absolute terms and relative to the assets and income of the council. Deputy chief executive Terry Collier was reported as saying:

No other single option would generate the level of savings and additional income that this particular opportunity presented... We are being very careful to make sure we understand the risks.⁴⁷

The *Financial Times* correspondent John Plender said in April:

In balance sheet terms, Spelthorne is now a property company with a sideline in providing local government services. Even for the best of motives, it is a highly risky bet.⁴⁸

- Eastleigh Borough Council has been reported as purchasing a range of assets such as shops, banks, pubs and offices. The most ambitious acquisition, according to the Local Government Association, has been the Ageas Bowl, home of Hampshire Cricket, where the council has invested some £40 million.⁴⁹
- The Times reported that Portsmouth City Council has acquired some £110 million of commercial properties across the UK:
Using £110m of debt, Portsmouth has so far bought properties including a DHL distribution centre near Birmingham, a Waitrose store in Somerset and a Matalan warehouse in Swindon. In December [2016], it sold a long lease on the Wightlink ferry terminal to the insurer Canada Life for £73m. ... [Council leader Donna] Jones said the deals were already producing £4.9m of annual income after interest. Combined with other measures, that means only £900,000 of the £9m budget cuts that Portsmouth must implement in the coming year [2017-18] will have to be passed on to residents through service reductions, she said.⁵⁰
- The Local Government Association reported that Basingstoke and Deane Council receiving £15.5m from its commercial property portfolio in 2012. The council also purchased the freehold of the Festival Place shopping centre, which gave it a 5-6 per cent annual return;⁵¹

⁴⁶ Colin Marrs, "[Spelthorne seals £360m sale-and-leaseback deal with BP](#)", *Room 151*, 6 October 2016

⁴⁷ Hiba Mahamadi, "[When it comes to commercialisation, we can't afford to do nothing](#)", *Municipal Journal*, 3 August 2017

⁴⁸ John Plender, "[UK public finance: councils build a credit bubble](#)", *Financial Times*, 25 April 2015

⁴⁹ Local Government Association, [Case Study: Eastleigh Borough Council](#), June 2011

⁵⁰ Oliver Shah, "[The great town hall property buying spree](#)", *The Times*, 9 April 2017

⁵¹ Local Government Association, [Emerging Council Innovation](#), May 2012, p1

- Sevenoaks District Council, in Kent, has bought a high street property for £4.1 million, plus a petrol station and convenience store in Swanley (£2.45 million), Suffolk House (£4 million) and Swanley Working Men's Club (£1.25 million). These are intended both as financial investments and as an element of the regeneration of the areas concerned.⁵²

3.2 Statistics on commercial property

Statistics showing local authorities' rates of acquisition, or holdings, of commercial property are not available. It would be challenging to identify funds that were used solely for commercial purposes: this would not be the case for most of the examples in the previous section, for instance. Figures for local authority spending on trading activities are available, but they do not indicate what use was made of the money. The Public Works Loan Board does not keep a record of the purpose of each of the loans it makes to local authorities.

Local authority statistics for England show a sharp recent increase in acquisitions of land and buildings using capital finance. Having been relatively stable at between £800m and £1.1bn from 2012 to 2016, provisional figures showed a sudden rise to £2.8bn in 2016-17.⁵³ An article on the local finance officer website *Room 151* attributed much of this change to commercial property strategies:

A breakdown of the figures shows that between April to June 2016, acquisitions totalled £340m, jumping to £912m during July to September, before falling slightly to 765m and £298m in the last two quarters respectively.

The biggest asset purchase by local government during the year was Spelthorne Borough Council's £380m investment in the BP Campus on its patch.

Other large deals included £180m on an energy-from-waste plant by Buckinghamshire County Council; Stockport Council's £80m purchase of the Merseyway shopping centre; Surrey Heath Borough Council's £103.6m acquisition of a town centre development and industrial park; and Leeds City Council's £45m deal to buy the city's 3 Sovereign Square office development.⁵⁴

The most recent statistical release from DCLG states that statistical categories are to be reviewed in order to reflect recent increases in commercial activity in local authorities:

...some local authorities have [recently] made capital investments wholly or partially for the purpose of revenue generation. Such activity has become difficult to define consistently within the categories used ... In light of the changing patterns of local authority capital expenditure, new sub-categories of commercial activities have been developed in liaison with local authorities and these will be used in future collections.⁵⁵

⁵² Sevenoaks District Council, [Council invests in offices in Sevenoaks](#), 24 March 2017

⁵³ See DCLG, [Local authority capital expenditure and receipts, England: 2016-17 Provisional Outturn and 2017-18 forecast](#), 15 June 2017

⁵⁴ Colin Marrs, ["Local government doubles spending on property and land"](#), *Room 151*, 22 June 2017

⁵⁵ DCLG, [Local Authority Capital Expenditure and Receipts, England: 2016-17 Provisional Outturn & 2017-18 Forecast](#), 15 June 2017, p.7

4. Previous local authority financial concerns

Media coverage of local authority commercial property strategies during 2017 has often included references to past examples of local authorities suffering financial difficulties. This section provides some details of three of the most often quoted episodes: Hammersmith and interest rate swaps in the late 1980s, Icelandic bank investments in the late 2000s, and LOBO loans in the mid-2010s.

Each of these episodes affected only a minority of authorities. None of them generated long-term serious financial strain or losses, though there were serious concerns in the short term. Nor did they require most councils to raise council tax substantially to offset a lack of funds. Nor did any of them generate a section 114 report (see section 2.3). LOBO loans in particular do not appear in practice to have had an adverse financial impact on any authorities.

Moreover, each of these episodes are different in character from one another and from the current development of property portfolios. They do not lead to any particular conclusions about the sustainability of commercial property investment.

4.1 Hammersmith and interest rate swaps

In 1987-89, the London Borough of Hammersmith and Fulham entered into a large number of transactions on the money markets. These consisted of the purchasing of derivatives, including 'interest rate swaps'. The nature of the deal was that if interest rates rose, the borough stood to lose considerable sums of money. Interest rates rose in February 1989, threatening a loss for the council of some £300 million.

The borough's auditor investigated the transactions, with the backing of the Audit Commission. In March 1989, the auditor applied to the High Court to have all derivative trades declared *ultra vires* (i.e. outside the powers of the council). The High Court found that interest rate swaps "did not facilitate a function, but rather the consequence of a function. They were therefore beyond the legitimate powers of a council".⁵⁶ This meant that Hammersmith's trades had no basis in law, and thus the swap contracts they had made with financial institutions could not be enforced.

This episode is regularly referred to as a cautionary tale for local authorities considering unusual financial instruments as a means of making money. But in legal and financial terms, it is very different from the acquisition of commercial property. Hammersmith's finance team had simply decided to invest cash held by the authority in the money

⁵⁶ Duncan Campbell-Smith, *Follow the Money*, 2008. Chapter 6 of this book, a history of the Audit Commission, provides extensive detail of the Hammersmith affair. This decision had contrasting effects for other local authorities, some of which had profited from derivative trades and had to surrender the money they had made.

markets instead of, for instance, a high-interest bank account. The subsequent financial problems were caused by unexpected and sudden shifts in interest rates. Also, unlike most commercial property strategies, Hammersmith's activities were purely financial and unconnected to any other duties and responsibilities of the council.

Interest rate shifts could constitute a risk to local authorities' financial strategies based on loans from the PWLB where these are on variable interest rates. Where they are based on fixed interest rates, this does not itself constitute a threat.

4.2 Icelandic banks

During the mid-2000s, a number of UK local authorities placed substantial sums on deposit with three Icelandic banks. Iceland's entire banking sector collapsed during the financial crisis of 2008-09, leading to long-term uncertainty over the status of deposits with them. Local authorities had made these deposits because of the very attractive interest rates that the accounts offered. In 2009, the Audit Commission produced a report entitled *Risk and Return*, which gave a picture of the degree of exposure of English local authorities:

- Icelandic deposits amount to about 3 per cent of the total on deposit.
- One hundred and twenty-seven authorities are affected.
- Thirty have funds greater than 5 per cent of gross revenue expenditure at risk.
- Councils are not expecting to cut services or increase council tax significantly as a direct result.⁵⁷

By 2014, the vast majority of these deposits had been recovered by local authorities.⁵⁸

Some of these deposits resulted from local authorities seeking to make profits from the spread between interest rates on certain deposits and interest rates on borrowing commitments:

The sums on deposit on 7 October 2008 far exceeded reported reserves. The money invested came from a number of sources, including reserves and other cash arising from, for example, the disposal of assets and the normal timing differences between receipt of income and expenditure. Additionally, some funds will have come from money borrowed in advance of need in order to take advantage of favourable interest rates, or from not repaying debt despite having the cash to do so.⁵⁹

As with Hammersmith, the lessons learned from the Icelandic banks affair relate to local authority treasury management decisions. Local authorities were criticised for placing funds with financial institutions which they did not subsequently monitor. Revisions to the Treasury

⁵⁷ Audit Commission, *Risk and return: English local authorities and the Icelandic banks*, 2009, p3

⁵⁸ Thomas Bridge, "[Councils recoup £1 billion lost to Icelandic ban collapse](#)". *LocalGov*, 5 February 2014

⁵⁹ Audit Commission, *Risk and return: English local authorities and the Icelandic banks*, 2009, p14

Management Code have since prevented the practice of borrowing money in advance of need. In some cases, local authorities placed additional sums with these banks even after they had been downgraded by credit rating agencies. This is a question of managing the authority's own money effectively, distinct from the viability of commercial investments.

The Communities and Local Government Committee investigated local authority investment decisions in the aftermath of the failure of the Icelandic banking sector. They concluded that practice varied across the sector:

..there are some local authorities with excellent treasury management services, but there are also local authorities with a less effective service. One of the objectives of the CIPFA Codes and Codes of Practice should be to ensure that all local authorities are aware of the level of expertise which is necessary to run a successful treasury management operation, and have all the checks and balances in place to ensure adequate monitoring, on an ongoing basis, of both the framework within which its treasury management team operates and the individual decisions which are made on a day-to-day basis.⁶⁰

....

We also recommend that the CIPFA Codes include guidance to local authorities on the nature of credit ratings, highlighting the risks of over-reliance on them. Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice.⁶¹

4.3 LOBO loans

In July 2015, Channel 4 broadcast an edition of *Dispatches*, [How Councils Blow Your Millions](#), concerning local authorities' exposure to Lender Option, Borrower Option (LOBO) loans.

This is distinct from the activities described in the two previous sections, as it concerns the terms on which local authorities borrow funds, rather than their management of their own funds. LOBO loans have not in practice caused financial difficulties to any individual councils to date.

LOBOs were briefly an attractive option to local authorities in the 2000s. PWLB loans carried a higher interest rate than in the 2010s (reflecting the respective base rates in those two decades). LOBOs are typically long-term (40-70 years). The lender has the option to increase the rates at fixed points in the loan term ('lender option dates'). The borrower must then either repay the loan plus a penalty fee, or move on to the higher rate of interest.

LOBOs typically offer the borrower a low 'teaser' interest rate for the first few years of the loan, to attract custom. Borrowers benefit to the extent that a LOBO rate undercuts the prevailing market rate, but lose if the prevailing market rate falls and the LOBO rate remains the same.

⁶⁰ CLG Committee, [Local authority investments](#), HC-164 2008-09, June 2009, p.22

⁶¹ Ibid., p.33

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LOBO loans are obtained from mainstream financial institutions, not from the Public Works Loan Board.

The *Dispatches* programme alleged that local authorities in England obtained £15 billion in LOBO loans between 2003 and 2011. The volume of new loans has decreased substantially since then, likely due in part to low base rates throttling the capacity of banks to offer 'teaser' rates.

In the light of the allegations in the programme, the Communities and Local Government Committee held a [one-off evidence session in July 2015](#). Witnesses included Anthony Barnett, the presenter of the programme and former director of Charter 88.

In October 2016, Melanie Dawes stated to the PAC:

Are we concerned about LOBOs? No, in the sense that they are no longer part of the offer that the banks make to local authorities. There is not, as far as we are aware, any lender offering those. ... One bank—Barclays—has in fact converted all their LOBOs into more straightforward fixed-rate loans, so they have taken away their own option to increase interest rates....as far as I am aware, there have not been any lender options exercised. The banks have not actually exercised the ability to raise the interest rates, and it may be that that product simply did not work for them in the way they expected it would.⁶²

The "Editor's blog" on the *Room 151* website suggested that a central lesson of the LOBO controversy was the need for councils to be aware of 'publicity risk', rather than the riskiness of the loans themselves:

LOBOs demonstrate that bad publicity is a risk that has to be taken into account when considering where to invest public money. And for property investment, the bad publicity involves no actual outcomes, no financial catastrophe or lost millions in public money. The reputational dangers come merely from warnings.

Of course, publicity risk may be entirely divorced from the underlying fundamentals, but it is a risk nevertheless and one that officers and politicians alike will now be pushing up the list of priorities. Indeed, it is likely to be a key determinant when councillors sit down with [section]151 officers and treasury managers to discuss potential property deals.⁶³

⁶² Public Accounts Committee, [Oral evidence: the financial sustainability of local government](#), HC 708, 10 Oct 2016, Q52-3

⁶³ Editor's Blog, ["Commercial property investment now a bad publicity risk"](#), *Room 151*, 4 May 2017

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