Report in the public interest under Schedule 7 Local Audit and Accountability Act 2014

Spelthorne Borough Council

Commercial property investments

Financial year ended 31 March 2018

1. **Summary**

1.1 This report raises a number of significant concerns identified in our role as independent auditor to Spelthorne Borough Council (**"the Council"**) regarding the Council's programme of investment in commercial properties and the implications of those transactions for its overall finances. In particular these concerns arose from the purchase of three investment properties during the financial year 2017/18. It is issued as a report in the public interest under Schedule 7 of the Local Audit and Accountability Act 2014 (**"LAAA 2014"**), which means that the Council must consider this report within one month and provide us with a formal response.

1.2 The Council (like many local authorities) has for some years sought to find ways to increase its income in response to funding cuts. From 2016 it started borrowing substantial sums of money from the Public Works Loans Board (PWLB) to fund investments in commercial property. This included borrowing over £400m to fund the purchase of a commercial property in Sunbury, from which it receives rent. We set out our concerns regarding the decision-making in relation to that purchase in our adverse opinion on the Council's value for money arrangements in our report on the accounts for 2016/17.

1.3 During the course of 2017/18, the Council borrowed over £225m from the PWLB to fund the purchase of three additional properties located outside of the Borough as commercial property investments. The purpose of these purchases was to generate income for the Council, on the basis that the rental income received from these properties would exceed the costs (including the costs of borrowing).

1.4 Following the 2017/18 financial year, the Council continued to borrow further amounts from the PWLB to fund commercial property investments, such that its total borrowing in this respect has now reached over £1bn.

1.5 This report sets out our concerns in relation to the purchases made in 2017/18, which may be summarised as follows.

1.6 <u>Legal issues</u>

In our view, supported by the advice of Kings Counsel, the Council acted unlawfully in borrowing and then purchasing the three properties in 2017/18 in two respects.

First, whilst the Council does, in a general sense, have powers to borrow and acquire properties, it did not in these circumstances possess the necessary legal powers to borrow to then purchase the particular properties.

(i) It could not rely on the "general power of competence" in the Localism Act 2011 (which allows local authorities to do anything which an individual may do) because local authorities acting for a commercial purpose must do so through a company. It did not purchase the properties through a company, rather in its own name.

(ii) It could not rely on the power to acquire land (section 120 Local Government Act 1972), because the purchase of the properties was not for *"the benefit, improvement or development of [the authority's] area"*; the purchases were simply made for investment purposes (i.e., to make a profit). Any benefit to the Council's area (through an increased income) was, and is, too indirect.

(iii) The powers to borrow and invest in sections 1 and 12 of the Local Government Act 2003 must be exercised for purposes relevant to the Council's functions (not relevant here as none were specified or are identifiable) or for *"the purposes of the prudent management of its financial affairs"*. Borrowing

in order to invest in the hope of achieving a profit is by its nature a different exercise from the prudent management of financial affairs.

Second, even if (contrary to our view) the Council did have the power to borrow and purchase the properties, it exercised this power unlawfully by failing to have regard to relevant statutory guidance:

(i) The Council was required by the Local Government Act 2003 to have regard to the (then) Department for Communities and Local Government's Guidance on Local Government Investments (second edition, 2010, as was applicable at the time). That guidance recommended the preparation of an annual investment strategy containing policies for the management of the authority's investments. The Council's 2017/18 investment strategy did not address investments in commercial property or acknowledge it was departing from that guidance, though the Council did adopt Strategic Property Investment Parameters in December 2017 at the same meeting at which it agreed to acquire the third of the three properties in question.

(ii) The Council was also required to have regard to Chartered Institute of Public Finance & Accountancy's Prudential Code for Capital Finance in Local Authorities, which said that *"Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed".* In our view, this is what the Council did (in this case borrowing more than was required), without any acknowledgement that it was departing from that Code.

(iii) Following statutory guidance is not mandatory in law, but the Council in each case failed to comply with the statutory requirement to "have regard" to that guidance, meaning that it had to consider the relevant aspect of the guidance and identify reasons for not complying with the guidance if it chose not to do so.

1.7 <u>Governance issues</u>

(a) In our view we consider that at the time the acquisitions under review were made, the Council had inadequate governance arrangements in place as it purchased its investment properties. Specifically, we found poor record keeping of the decision-making process, a lack of a clear investment strategy leading to a number of weaknesses (such as an investment portfolio that lacks diversification), and a lack of in-house expertise in this type of investment at the time of the acquisitions. The purchases discussed in this report contributed to a position where the Council has now borrowed more than £1 billion to fund a commercial investment property portfolio. For the 2017/18 properties in question, it did so without following expected industry guidance, was overseen by an inexperienced team, and exposed the Council to a potentially high level of financial risk.

1.8 <u>Financial issues</u>

(a) In our view we consider that there are a number of financial issues that the Council needs to consider and address to help ensure the Council remains financially sustainable. The financial models that were developed by the Council are simplistic in nature and do not follow industry best practice. Whilst we consider that the Council was earning sufficient rental income to meet its loan repayment obligations in the short term, we are concerned that this may not be the case in the medium to longer term.

(b) The Council's predicted internal rate of return on the investment property portfolio is, in our view, well below the level that an institutional investor would expect to achieve. Furthermore, we consider there is a risk that the modelled rental income may be overestimated, and potential costs have been understated. If this is proven to be the case this would further reduce the internal rate of return.

We acknowledge that the Council may have different return objectives, however, the scale of the investment is akin to an institutional investor, and this should, therefore, be taken into account.

(c) The lack of sophistication in the Council's financial models has, in our view, created a disconnect between the lease lengths (up to 20 years) and the loans (50 years). Whilst the loans have been structured with varying maturity dates between 1 and 50 years, £468 million of loans exceed the 20-year lease period. This reduces clarity in the assessment of the medium- to long-term financial impact on Council finances.

1.9 <u>Our decision to make a public interest report</u>

Since 2017/18 there have been a number of developments which have informed our decision to make a public interest report on this matter, rather than seeking a declaration from the Court that the Council acted unlawfully. The Council disagrees with our legal analysis. Independently of this, however, it since brought its policy of borrowing to invest in commercial property to an end. The relevant guidance discussed in this report has been updated to make it clearer that local authorities should not borrow more than or in advance of need purely to profit from the extra sums borrowed. There is further emphasis on the requirement to ensure that borrowing and investments are proportionate (for example, compared to service expenditure or the level of its resources). There has also been a change to the terms of borrowing from the Public Works Loan Board which essentially prohibit local authorities borrowing from that source for the purpose of acquiring assets to make a profit.

1.10 We have therefore decided that a public interest report highlighting our concerns – and drawing them to the attention of the public – is a more appropriate way forward, rather than taking formal legal action by asking the Courts to declare an item of account unlawful (the costs of which would ultimately fall on the taxpayer).

2. Introduction

2.1 KPMG LLP is the auditor for Spelthorne Borough Council (**"the Council"**) for financial year 2017/2018. This report raises a number of significant concerns identified in our role as independent auditor to the Council regarding its programme of investments and the implications for its overall finances. These concerns arose from the purchase of three investment properties during the financial year 2017/18. It is issued as a report in the public interest under Schedule 7 of LAAA 2014, which means that the Council must consider this report within one month and provide us with a formal response.

2.2 This report sets out the background to the matter, and our concerns regarding the legal, financial and governance implications of the Council's actions in 2017/18.

2.3 A copy of this report has been sent to the Secretary of State as required by LAAA 2014.

3. Background

3.1 <u>Our work</u>

3.1.1 This matter was brought to our attention as the Appointed Auditor as part of our audit of the Statutory Accounts for 2016/17 and 2017/18.

3.1.2 We therefore investigated the issues raised within our remit and this report sets out our findings in relation to the process that the Council went through in the acquisition of investment properties.

3.1.3 In thematic terms our work can be summarised as being a review of the Council's stewardship of public money, and to achieve that by:

a. looking at the decisions to accept and enter into the transactions in accordance with the Council's policies

b. reviewing the legality of the decision to purchase the investment properties and subsequent action

c. reviewing the financial modelling of the investment property acquisitions

d. reviewing the governance over the decisions, including to purchase the investment properties and subsequent action

e. reviewing and considering the performance management and value for money arrangements for the investment property acquisitions

f. critically assessing the management information with regards to the investment property acquisitions

g. reviewing the financial controls over the transactions.

3.2 Factual background

3.2.1 In 2014, the Council launched the "Towards a Sustainable Future" programme, the objective of which was to enable the Council to become self-funding (and not reliant on Government grant) by 2020.

3.2.2 In February 2016, the Council adopted an investment strategy and a treasury management strategy, though importantly these strategies did not mention making investments in commercial property to generate income. Around the same time, the Council's report on the capital programme 2016/17 – 2019/20 included an allocation of £6m shown as an accepted capital growth bid. The note to this allocation suggested that the Council would need to consider whether it would wish to start acquiring property for investment purposes, and that such a decision would need to be informed by a Property Investment Strategy with its own capital budget. It suggested setting aside a capital budget in the interim in case there were opportunities to acquire assets for regeneration or service provision purposes.

3.2.3 On 7 April 2016 the Council approved a request for supplementary capital expenditure for property acquisitions of up to £29m for 2016/17 (*"for service provision – specifically for affordable housing and emergency accommodation, economic and social regeneration or to generate an on-going income stream"*). It also approved a revised set of prudential indicators which included the operational boundary and authorised limit for external debt.

3.2.4 The decision-making documents from July 2016 onwards show a shift towards a focus on income generation. A report to Council on 21 July 2016 explained, in the context of the "Towards a Sustainable Future" programme, that a number of significant opportunities had arisen to purchase commercial properties which would be capable of generating considerable levels of income and enable the Council to support the ongoing economic well-being of the Borough. The report suggested that there was a need for the Council to be in a clear position to act on any opportunities presented by the market and make decisions promptly, which necessitated an increased borrowing limit. It stated that local authorities were in a strong financial position to acquire property due to their ability to access

capital, coupled with the low cost of borrowing. The report noted that officers had sought advice from treasury management advisors, who were comfortable with the level of borrowing envisaged.

3.2.5 The Council approved an additional supplementary capital estimate for property acquisitions within the Borough of £400m for 2016/17 to support the economic development and well-being of the borough and investment purposes. It also agreed a revised set of prudential indicators which included increasing the operational boundary and authorised limit for external debt. The capital estimate and authorised limit were subsequently increased further in respect of later purchases.

3.2.6 During the course of 2016/17, as part of the "Towards a Sustainable Future" programme, the Council purchased a property (known as the **"BP Campus"**) for £385 million, financed through loans of £405 million from the Public Works Loans Board (**"PWLB"**). The purchase was made as an investment in order to generate revenue streams from payments of rent.

3.2.7 In December 2016 the Council approved a supplementary capital estimate for property acquisitions within the Borough of £80m for the remainder of 2016/17.

3.2.8 During our audit of the 2016/17 accounts, we identified a number of concerns in relation to the purchase of the BP Campus. As a result, when issuing our report on the accounts we did so with an adverse value for money arrangements conclusion.[1] The report noted our view that there were significant weaknesses in respect of those arrangements, including:

(a) Poor record keeping in relation to the decision-making process.

(b) A lack of clarity around the potential financial impact for the Council if BP were not to renew the lease after 20 years (the length of the lease), in circumstances where the costs of the loan need to be met for 50 years.

(c) A delay in publishing the required details of the decision and inaccuracies in that publication.

(d) A failure to formally document consideration of whether the purchase was on such a scale that it represented a disproportionate share of the Council's capital programme, as recommended by the Council's legal counsel. This indication in particular heightened our ongoing concerns.

3.2.9 In February 2017, the Council approved a treasury management strategy and capital programme for 2017/18. The capital programme included a £200m provision for asset acquisitions. The strategy referred in general terms to some of the statutory guidance mentioned below. It also referred to the importance of the identification, monitoring and control of risk given that the Council had borrowed and invested substantial sums of money and was exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. It mentioned the possibility of borrowing in advance of need but did not discuss the legal issues around doing so (or whether such a course of action was appropriate) – see section 4.7.6 below. At this stage there was no property investment strategy in place. The capital programme referred to the relevant statutory guidance (by reference to the prudential regime) in general terms. It said:

> *"The use of borrowing under the prudential regime can be considered on a scheme-by-scheme basis where appropriate. On <u>an invest to save or invest to generate income scheme</u>, if the savings exceed potential borrowing costs then there may be a business case to borrow. The Council has pro-actively evaluated and grasped opportunities which both further the economic wellbeing of the Borough but also provide a net income stream for the Council. The*

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[1] Independent auditor's report to the members of Spelthorne Borough Council, 19 February 2019.

acquisition of BP International Campus was a prime example. The Council's asset base is being kept under constant review and wherever possible additional resources will be generated from the disposal of both under performing and surplus assets" (original emphasis).

3.2.10 During the course of 2017/18 the Council made further purchases as follows (**"the 2017/18 Properties"**):

(a) 3 Roundwood Avenue, Stockley Park – £21.4 million (July 2017);

(b) World Business Centre 4, Heathrow – £47.2 million (September 2017); and

(c) Hammersmith Grove – £160 million (January 2018).

3.2.11 The purchase of each of the three properties was approved by the Council's cabinet, approving the recommendation made in a written report from officers. The minutes from the meetings at which the purchases were approved record the reason for the decision being as follows: *"Acquisition of the asset will bring in a steady income stream for the term of the lease. The income stream will assist in the future long term financial stability of the Council"* (with a slight variation of wording for the Hammersmith acquisition).[2]

3.2.12 As with the BP Campus, these purchases were funded through borrowing from the PWLB, as recommended in the officer reports supporting each of the decisions. Those reports noted that local authorities were in a strong financial position to acquire property due to their ability to access capital, coupled with the low cost of borrowing (suggesting that at that time, the Council could borrow at 1.5% to 2.5% from the PWLB, whereas a developer would be likely to pay 5 - 6%). The reports also set out the anticipated net annual surplus, after accounting for various costs, including those relating to borrowing.

3.2.13 Each of the 2017/18 Properties are outside of the Council's boundary.

3.2.14 On 12 December 2017, at the same meeting at which the Cabinet approved the acquisition of Hammersmith Grove, the Cabinet approved a set of "Property Investment Strategic Parameters", which outlined the purposes for which the Council was to invest in property acquisitions, and the conditions which were required to be met for investing for revenue generation and/or social investment purposes. The timing of the approval of these parameters was such that these were not in place to provide a framework within which the acquisitions in the period to the end of 2017/18 were made (though the Officer's report in respect of the Hammersmith Grove purchase noted that Cabinet was considering a report on the Property Investment Strategic Parameters at the same meeting, and that the acquisition was in line with the guidelines set out in that document).

3.2.15 The Council continued to make further commercial property purchases after the 2017/18 financial year, such that it currently now holds 11 such assets, funded by borrowing in excess of £1bn. The Council's capital strategy, as updated in March 2020, reflects a shift away from investment in commercial property to generate income to focus on other investment objectives (housing development, and regeneration).[3]

3.2.16 As part of the audit of the 2017/18 accounts, we have been discussing with the Council its approach to the purchase of the properties. In particular, we asked the Council to provide information

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[2] Minutes of Cabinet 27 April 2017, 2 June 2017, 12 December 2017.
[3] See paragraph 6.5 of the 2020 Strategy: https://www.spelthorne.gov.uk/capitalstrategy

as to how it had complied with various duties, including whether it complied with the requirements contained in Chartered Institute of Public Finance & Accountancy's (**"CIPFA"**) Prudential Code for Capital Finance in Local Authorities (**"the Prudential Code"**) or the statutory guidance issued by the (then) Department of Communities and Local Government on local government investments.

3.2.17 Throughout the course of this engagement, it became clear that the Council took a different view to us regarding the legal, financial and governance implications of investing in commercial property. We have set out our conclusions in each of these areas below, including noting the Council's view where appropriate.

3.3 Wider context

3.3.1 In response to decreasing funding since 2010/11, it has been increasingly common for local authorities to seek to offset necessary reductions in spending by employing strategies to generate income. One such strategy has been the acquisition of commercial property, often funded by borrowing from the PWLB. Our view has been that borrowing purely in order to invest and make a profit is generally likely to be unlawful, though we are aware that others (including the Council) do not share this view.

3.3.2 Both CIPFA and the Government have made changes to statutory guidance in an attempt to clarify the position. The Department of Communities and Local Government's 2010 Guidance on Local Government Investments (second edition),[4] which was in effect in relation to the 2017/18 year of account, was replaced in 2018 by a third edition.[5] This guidance is clearer on the key issues of borrowing in advance of need in order to make a return, and the concept of proportionality (for example, ensuring that borrowing and investments are proportionate to service expenditure or the level of resources). Similarly, the 2011 Prudential Code was replaced in 2017 by an updated edition which provides further guidance on these issues, and CIPFA are consulting on additional updates.

3.3.3 There have been a number of additional developments in relation to these issues since the 2017/18 year of account, in particular:

(a) A National Audit Office report on local authority investment in commercial property (13 February 2020), drawing attention to the scale of investment in recent years and raising questions about aspects of the prudential framework and the efficacy of its oversight;[6]

(b) The House of Commons Public Accounts Committee's report on local authority investment in commercial property (13 July 2020), which is critical of the Government's grasp of the relevant risks and refers to the Council specifically.[7] The Government responded in October 2020 with its plans to improve its stewardship of the local government capital system.[8]

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[4] https://webarchive.nationalarchives.gov.uk/20180105114721/https://www.gov.uk/government/publications/capital-finance-guidance-on-local-government-investments-second-edition.

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/678866/Guidance_on_local_government_investments.pdf.

[6] https://www.nao.org.uk/report/local-authority-investment-in-commercial-property/

[7] Available: https://committees.parliament.uk/work/273/local-authority-commercial-investment/publications/. Note that the Council submitted written evidence on 18 May 2020, available: https://committees.parliament.uk/writtenevidence/4209/pdf/.

[8] https://committees.parliament.uk/publications/2948/documents/28297/default/

(c) In July 2021, the House of Commons Housing, Communities and Local Government Committee published its report on local authority financial sustainability and the section 114 regime. The report recommends that the Government legislates to make compliance with the Prudential Code by local authorities a statutory duty, rather than the current duty to have regard to it. CIPFA published its new Prudential code on 20 December 2021. CIPFA has stated that *'the provisions in the Code, which present the approach to borrowing in advance of need in order to profit from additional sums borrowed, have been strengthened. The relevant parts of the Code have augmented to be clear that borrowing for debt-for-yield investment is not permissible under the Prudential Code. This recognises that commercial activity is part of regeneration but underlines that such transactions do not include debt-for yield as the primary purpose of the investment or represent an unnecessary risk to public funds*."[9]

(d) The PWLB terms have been revised *"to end the situation in which a minority of local authorities used PWLB loans to support the acquisition of investment assets bought primarily for yield"*.[10]

[9] https://www.cipfa.org/about-cipfa/press-office/latest-press-release/cipfa-issues-new-prudential-and treasury-management-codes

[10] See PWLB Guidance for Applicants – August 2021: https://www.dmo.gov.uk/media/17634/pwlb-guidance-for-applicants-august-2021-a.pdf

4. **Legal issues**

4.1 Legal advice

4.1.1 We note that the Council obtained KC advice on its powers to borrow to invest in the BP Campus purchase. The Council did not at the time obtain specific advice on its powers to borrow and purchase the 2017/18 Properties. The officer reports for those purchases referred to that previous advice but did not specify which powers were relied on in each case (the previous KC advice referred to a number of possible powers) or explain why the relevant legal test was met.

4.1.2 *Recommendation: The Council should obtain legal advice on its powers to enter into specific transactions where those transactions are unusual or high value.*

4.1.3 *Recommendation: Officer reports should clearly identify the legal powers relied on in relation to decisions or transactions and ensure that decision makers are aware of the relevant legal test to lawfully exercise those powers.*

4.2 Legal powers

4.2.1 It is not in doubt that local authorities have powers to borrow, and powers to invest. We outline below our understanding of the law in this area and why, based on our KC advice, we consider that the Council has acted unlawfully in this particular case. The Council has subsequently to the borrowing and purchasing and in response to this investigation received its own KC advice.

4.2.2 The potential sources of power for borrowing are:

(a) The general power of competence (**"GPOC"**) in section 1 of the Localism Act 2011 (**"LA 2011"**), which subject to certain constraints, allows for local authorities to do anything that individuals generally may do (contrary to the normal principle that public bodies may only do that which they are empowered to do by law).

(b) Section 1 Local Government Act 2003 (**"LGA 2003"**), which provides an express power to borrow for *"any purpose relevant to [the authority's] functions under any enactment"*, and for *"the prudent management of its financial affairs".*

4.2.3 In relation to powers to purchase (in this case, to invest in) property:

(a) The GPOC could be used;

(b) There is a power to acquire land inside or outside a local authority's area under section 120 of the Local Government Act 1972 (**"LGA 1972"**) for the purposes of any of the local authority's functions any enactment, or for the benefit, improvement or development of their area;[11]

[11] Section 120 LGA 1972:
"(1) For the purposes of—
(a) any of their functions under this or any other enactment, or
(b) the benefit, improvement or development of their area,
a principal council may acquire by agreement any land, whether situated inside or outside their area.
(2) A principal council may acquire by agreement any land for any purpose for which they are authorised by this or any other enactment to acquire land, notwithstanding that the land is not immediately required for that purpose; and, until it is required for the purpose for which it was acquired, any land acquired under this subsection may be used for the purpose of any of the council's functions. …"

(c) There is a power to invest for any purpose relevant to an authority's functions under any enactment, or for the purposes of the prudent management of its financial affairs under section 12 LGA 2003.

4.3 GPOC

4.3.1 We consider that the Council cannot rely on GPOC for the borrowing related to the 2017/18 Properties and the purchase of those properties. The Council was acting for financial gain, and therefore acting for a commercial purpose. Local authorities may only rely on GPOC when doing things for a commercial purpose if they do them through a company (section 4(2) LA 2011). The Council was not acting through a company in this case.

4.3.2 We understand that the Council disagrees with our view that the GPOC was not available in this case. It regards acting for a commercial purpose and investing as two separate and mutually exclusive concepts and says in this case the Council was investing such that it could rely on GPOC without acting through a company.

4.3.3 We however consider that the Council was acting for a commercial purpose, whether or not it was also investing in the properties. We have not been given any compelling reason as to why the LA 2011 should be interpreted, contrary to the plain English meaning, that acting for a commercial purpose and investment are two mutually exclusive concepts. The sole or dominant purpose of the transactions was to make a profit (a commercial purpose), and the fact that they may also be classified as "investments" does not alter that. As such, we do not consider that the Council was entitled to rely on GPOC for the borrowing related to the 2017/18 Properties and the purchase of those properties, given that it did not do so through a company.

4.4 Power to acquire land under section 120 LGA 1972

4.4.1 In our view, the Council could not reasonably rely on section 120 LGA 1972, because it was not acting for any of its statutory functions or for the benefit, improvement, or development of its area. This is in contrast to the Council's view, which suggests that concept of "benefit" in section 120(1)(b) is broad enough to embrace improvement in the authority's general financial position, provided that there was *"an identified and reasonably well-defined outcome in terms of benefit"*. However, we consider that simply generating income from the purchases of the 2017/18 Properties and using that money for services in the area (rather than generating some benefit from the use of the land itself) is too indirect to constitute a relevant benefit for the purposes of section 120 LGA 1972. We note further that none of the relevant decision-making reports concerning the purchase of the 2017/18 Properties referred to section 120 LGA 1972 or addressed the test set out in that provision (or identified the well-defined outcome referred to above). In other words, there is no evidence that the Council was seeking to purchase the 2017/18 Properties for "*benefit, improvement or development of their area"* (or was satisfied that it was aiming to do so), rather than simply aiming to secure income streams.

4.5 Borrowing and investment powers under sections 1 and 12 LGA 2003

4.5.1 We do not consider that the Council could rely on sections 1 or 12 LGA 2003. The investments were not made for purposes relevant to the Council's functions (section 12(a) LGA 2003): the investments were purely for the generation of income and not for any functional purpose. In our view, an investment is not undertaken for the prudent management of an authority's financial affairs within section 12(b) of LGA 2003 if the sum to be invested has only been generated by an act of borrowing undertaken specifically to fund that investment. Contrast this to a situation where a local authority invests money obtained further to the disposal of an asset, rather than retaining the capital sum: this

would more obviously constitute prudent management. Similarly, in the case of the borrowing power under section 1 LGA 2003 (see below), prudential management might involve borrowing in order to repay an existing loan which is on a higher rate of interest than is available now.

4.5.2 In the case of the 2017/18 Properties, the Council was only able to invest because it had borrowed, and the sole purpose of its investment was to make a profit, rather than seeking to manage its funds in a prudential manner. In the example of the authority investing the capital sum that resulted from the disposal, the Council is seeking to prudently manage the existing state of affairs; by borrowing for the purpose of investing, however, the Council is creating a new state of affairs which requires management. The two types of transactions are completely different in nature, and we do not consider that borrowing to invest at a hoped-for profit falls within the scope of the investments envisaged by Parliament as being an exercise of the power to borrow/invest for the purpose of the prudent management of a local authority's financial affairs.

4.5.3 A general power to borrow for the purposes of speculation in our view goes beyond what Parliament intended through the LGA 2003. While the wording of section 1(b) and 12(b) is broad, there must be some limits (beyond public law, also known as *Wednesbury,* reasonableness) to the exercise of these powers, or else there would have been no need for a separate clause governing borrowing/investing for purposes relevant for the Council's functions (in section 1(a) and 12(a)).

4.5.4 The Council adopts a different interpretation of sections 1 and 12 LGA 2003: when an investment is an exercise of prudent management of financial affairs, it considers that borrowing to achieve that investment may also be an exercise of prudent management of those affairs. It considers that borrowing to invest may be part of the prudent management of financial affairs.

4.5.5 In our view, the Council's interpretation essentially seeks to assume an approach where prudent management of financial affairs always authorises borrowing to make a profit, so long as the particular transaction can be characterised as a prudent one on its facts. We do not think that this is the approach envisaged by Parliament, or that it intended to confer a power to borrow for the purposes of financial speculation, limited only by *Wednesbury* reasonableness, prudence on the facts, and the authority's overall borrowing limits.

4.6 In summary, we do not consider that the Council could rely on sections 1 and 12 LGA 2003 in borrowing for and purchasing the 2017/18 Properties.

4.7 <u>The exercise of the Council's powers</u>

4.7.1 In order to act lawfully, a local authority must not only possess the necessary powers to take the relevant action, but also exercise those powers within the limits of the law. In this regard, separately from the issue of legal powers (which we acknowledge may be open to interpretation, and only a Court could definitively decide), we consider that the Council acted unlawfully in the way in which it exercised any powers it did have.

4.7.2 The Council was required by section 15 LGA 2003[12] to have regard to guidance issued by the Secretary of State when exercising its borrowing or investments powers (under section 1 or 12 LGA 2003 respectively). The relevant guidance in force at the time of the 2017/18 transactions was the

[12] Section 15(1):
"(1) In carrying out its functions under this Chapter, a local authority shall have regard—
(a) to such guidance as the Secretary of State may issue, and
(b) to such other guidance as the Secretary of State may by regulations specify for the purposes of this provision."

(then) Department for Communities and Local Government's (**"DCLG"**) Guidance on Local Government Investments (second edition, 2010). The Council was also required to have regard to the CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (2011 edition) under section 15 LGA 2003, and also to CIPFA's Prudential Code for Capital Finance in Local Authorities (2013 edition) when complying with its duty under section 3(1) LGA 2003 to determine its affordable borrowing limit.[13]

4.7.3 A statutory duty "to have regard" to guidance does not mean that a local authority is always required to follow that guidance. Rather, it means the local authority must give proper consideration to the guidance and if it proposes to depart from it, the authority must identify clear (proper and legitimate) reasons for doing so.

4.7.4 In our view, the Council acted unlawfully by failing to have regard to the DCLG Guidance and the Prudential Code as set out below.

4.7.5 <u>DCLG Guidance</u>

(a) The DCLG Guidance on Local Government Investments recommended the preparation of an annual investment strategy containing policies for the management of the authority's investments, and for giving priority firstly to the security of those investments, and secondly to their liquidity.[14] The Council had an investment strategy at the relevant times, and the 2017/18 investment strategy referred to the DCLG Guidance and CIPFA guidance in high level terms. However, it did not address the investments in the 2017/18 Properties or more broadly investments in commercial property. Neither did it acknowledge that this was a departure from the DCLG Guidance or give reasons for so departing. In our view, there was therefore an unlawful failure to have regard to the DCLG Guidance at least in relation to the 3 Roundwood Avenue, Stockley Park and World Business Centre 4 properties. The position is less clear in relation to the 12 Hammersmith Grove property: as noted above, the Cabinet approved a set of "Property Investment Strategic Parameters" at the same meeting on 12 December 2017 at which the Cabinet decided to proceed with the acquisition of that property.

(b) We note that the above conclusion is based on our view that the purchases of the 2017/18 Properties were investments for the purposes of the DCLG Guidance. This term is defined in that guidance as a *"transaction which relies upon the power in section 12 [LGA 2003] and is recorded in the balance sheet under the heading of investments within current assets or long-term investments".* The 2017/18 Properties should be classified as investments in the balance sheet. As noted above, the Council in its decisions did not identify the power on which it was purporting to rely in relation to the purchases of the 2017/18 Properties. In our engagement with the Council, section 12 LGA 2003 is one of the powers on which it is said that the Council could have relied. If it is correct on this point, then it was required to have regard to the DCLG Guidance as explained above.

(c) It is worth noting that the informal commentary to the DCLG Guidance expressed the informal view that the speculative procedure of borrowing purely to invest at a profit is unlawful (noting that DCLG could not offer an authoritative interpretation of the law).

4.7.6 <u>The Prudential Code</u>

(a) The Prudential Code in force at the time stated that authorities *"must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed."* The

[13] See regulations 2 and 24 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.
[14] Paragraph 4.2.

non-statutory guidance supporting the Prudential Code, said (in relation to section 1(b) LGA 2003) that *"…the speculative procedure of borrowing solely in order to invest and make a return remains unlawful".*

(b) The Council entered into loans for which there would have been no need had it not been for the acquisition of the commercial property assets for the purposes of making a profit. In doing so, the Council was borrowing more than it needed contrary to the prohibition against doing so in the Prudential Code.

(c) The Council was only required to "have regard" to the Prudential Code (rather than to comply with it). However, there is no evidence that the Council did have regard to the relevant guidance in the Prudential Code, or that its members were aware that they were departing from it when considering the 2017/18 Properties (to be clear, there are some references in the relevant reports to the Prudential Code generally, but the reports do not consider the prohibition on borrowing more than is needed in order to profit from the investment of the additional sums borrowed). No reason was given for departing from the Prudential Code, as would have been required to depart from the Code lawfully. As such, in our view, these failures render the Council's decision making unlawful (even if the Council did have the necessary powers as considered in the section above).

(d) The Council has suggested that it did not borrow in advance of its needs (one limb of the prohibition in the Code), because the borrowing was undertaken for a present (imminent) investment and the investment was to fund a present need. However, even if correct, this overlooks the other element of the relevant prohibition in the Prudential Code, which is that a local authority should not borrow "more than" it needs in order to profit from the investment.

(e) For completeness, we note that the requirement to have regard to the Prudential Code arises in the context of the section 3(1) LGA 2003 duty regarding the determination of the Council's affordable borrowing limit. As explained in the factual background, the Council increased its borrowing limit at various points to facilitate borrowing in order to make various commercial property investments, including the 2017/18 Properties. Even if (contrary to our view) the requirement to have regard to the Prudential Code did not apply directly to the decisions to borrow and invest in the 2017/18 properties, it was a relevant consideration to which the Council should have had regard (and failure to do so was unlawful in public law terms).

4.7.7 *Recommendation: The Council should ensure that it has regard to all relevant statutory guidance, including specific aspects of that guidance that apply to particular decisions or transactions, and specifically record its reasons for departing from such guidance if it decides to do so.*

4.8 Implications for the transactions

4.8.1 It is worth emphasising that despite our view that the Council had acted beyond its powers and that its decisions were unlawful for failure to have regard to the relevant statutory guidance, we have not concluded that this would render the transactions (that is the borrowing or acquisitions) a nullity or unenforceable. The transactions in question were not outside the strict capacity of the Council (i.e., borrowing and acquiring properties are things that in principle the Council had the power to do). Rather, the legal issues stem from the particular way in which the acquisitions were being financed, the purpose for which the borrowing was undertaken, and/or in the decision-making process.

5. Financial issues

5.1 The Council fully leveraged its purchases of its investment property portfolio. This was enabled by the Council's access to low interest long term loans provided by the Public Works Loans Board.

5.2 The following table illustrates the increase in the Council's long-term assets, liabilities, and income.

	Long Term Assets (£000)	Net assets/ (liabilities) (£000)	Long term liabilities (£000)	Income (£000)
2015/16	71,115	39,736	34,923	59,461
2016/17	474,719	6,508	450,222	77,158
2017/18*	730,008	452	695,460	79,755
2018/19*	1,101,163	(13,145)	1,093,830	119,874
2019/20*	1,162,549	(1,120)	1,103,103	150,808
2020/21*	1,128,105	(22,862)	1,113,317	151,899

** Subject to audit*

For the past three years the Council is in a net liability position which has primarily been brought about by the decrease in the valuation of the investment properties which is reflected in the Council's negative revaluation reserve. The Council's income has increased through the rental income that it now receives.

5.3 The Council has been able to meet its loan repayment commitments from the rental income it has received. In the shorter term the Council should still be able to meet its loan repayments. However, in our view, what is not clear, is whether this can be maintained, based upon the financial models that the Council developed and the limited sophistication in the stress testing and sensitivity analysis that has been applied.

5.4 The Council has developed a separate model for each of the investment properties that it has purchased. Our review of these models found:

- No rental growth has been factored into most of the models. A commercial real estate investor would model the lease terms agreed to forecast the revenue. Whilst this could be considered prudent to factor no growth, it demonstrates the basic nature of the models.

- The Council's estimated rental value and rental value at renewal are hardcoded directly into the models and the logic behind the assumptions is not apparent. There also appears to be an inconsistent approach between the various financial models.

- The Council's financial models assume that tenants will not exercise their break options. Typically, it is common that some tenants will exercise their break options, and the shortest lease period should be modelled along with the costs that will be required for preparing the property for re-marketing and letting, as part of the stress testing and sensitivity analysis for each property.

- The Council has assumed a void period of 12-15 months for a 10-year lease. According to Avison Young the convention would normally be for a 12–24 months void period for a 10-year lease. The Council could be under-estimating void periods, based on this.

- The Council assumed a rent-free period of 12-24 months for a 10-year lease. According to Carter Jonas, in their London office rent and period guide -Q1 2018, most 10-year leases had a rent-free period of 19-24 months especially for space above 5,000 sq ft. The Council could be overestimating its income assuming shorter rent-free periods.

5.5 Most commercial real estate leases in the UK are typically full, repairing and insuring leases ("FRI Lease"). This is a lease in which the tenant takes on all the costs for repairs and insurance for the property being leased from the landlord. As such, we would not expect the Council's cost base to be large. We highlight that the Council has not provided detailed breakdowns of all costs in the expected or worse case model. This is unusual and it makes it harder to analyse and then demonstrate the Council's assumptions are reasonable. Instead, a selection of cost items can be found in a supporting spreadsheet document. Good practice would have included these costs in the cash flow model. This would have resulted in the yearly income and internal rate of return decreasing. For example, if the World Business Centre 4 incurred 1% of paid rent for property management cost and 1% of the asset sale price for sale cost, the internal rate of return ("IRR") calculated by the Council would have been 4.05% as opposed to 4.20%. The cash flow models do not include costs that we would have expected to see. These include property management fees, leasing commissions, rent review costs, non-recoverable property expenses (such as marketing fees), general administration fees, dilapidation costs and future capital expenditure. There is a risk that the Council has underestimated its costs.

5.6 The Council purchased the real estate assets with PWLB loans. The model assumes a fixed interest rate of 2.00% – 2.50% payable on the amounts of the loans secured, representing the average PWLB rates at the time of acquisition. The tenor of the debt is over a 50-year period, incorporating 50 separate loans for each investment property with one loan maturing and requiring repayment in each of the 50 years. However, the cash flow is a 20-year projection, and the leases are of varying lengths less than 20 years. Hence, there is a mismatch of the income and debt profile. A commercial real estate investor would ensure that the asset's holding period matches the debt profile in their model.

5.7 Furthermore, the lease lengths of less than 20 years do not align with the debt tenor of the 50-year period profile. This results in renewal and repayment mismatch risk to the extent there is debt outstanding at the end of the lease period, of which this is expected to be the case across all properties (including those purchased in 2017/18), and which exceeds the recoverable value plus any accumulation in the sinking funds. For example, in the purchase of the BP campus, though completed in 2016/17, provides a good example of the potential issues. After the expiry of BP's lease, the debt outstanding is £295m. We understand that the Council may have mitigated its rental income risk by securing leases with high credit quality tenants, however, the credit quality of lessees can fluctuate over the life of the lease. The change in credit quality could be due to a range of factors such as economic or industry specific conditions and this remains a factor which does not appear to have been properly considered.

5.8 Commercial property investors have a Loan to Value (LTV) assumption in their model if they use debt to purchase the asset. This amount is typically around 60-65% for senior debt, or lower. The Council's investment property purchases were fully leveraged. Following the 2008 financial crisis, there were changes in regulations, and banks became more prudent and have since reduced their LTV levels substantially. The structure of the Council's transactions, i.e., on the balance sheet as opposed to the debt being secured against the Properties, means that Council would be liable for the debt payment irrespective of the performance and value of the assets.

5.9 The IRR Investment multiple and profit are some of the key profitability outputs that commercial real estate investors use in decision making. The multiple is the net income throughout the life of the project relative to the acquisition price. The multiple is of particular interest to investors as it shows the amount invested relative to the gains. The profit is the sum of the net cash flows generated from the investment throughout the life of the transaction. These calculations are typically run on an unlevered (pre-debt) and levered basis (post debt repayment); however, it does not appear that the Council has calculated any of these outputs. Instead, the Net Present Value (NPV) has been calculated using the Treasury Green Book rate as the discount rate. This approach for NPV calculations is common amongst

Local Authorities, but given the size of investment, consideration should also be given to the IRR to be more closely aligned to an institutional investor.

5.10 The IRR is the annual growth rate an investment is expected to generate or the discount rate that makes the NPV of all cash flow equal to zero. The IRR stated by the Council is between 3 and 5%. However, this is based on the rent received in real terms. We have rarely seen commercial real estate investors adjust the rental income profile into real terms before calculating the IRR and this is not considered to be good practice. Additionally, the Council has not accounted for certain costs meaning that the IRR could be lower. It is uncommon that a commercial real estate investor would invest in a project at the Council's IRR levels, which would be considered to be too low.

5.11 The IRR is also proportional to the risk the investor is willing to take. A new prime building in central London let for 20 years to a blue-chip tenant might produce a leveraged IRR of 5-7%, which could be suitable for a "Core Investor" (pension funds and other institutional investors). Less risk-averse investors such as family offices and private equity funds might have higher target levered IRRs of 10-15% taking on more risky assets e.g., higher vacancy rates, short leases or need for refurbishments, often outside of the super prime locations. We note that the levered IRRs have not been calculated in the Council's models.

5.12 We recognise that when the Council made decisions to acquire investment properties, it could not have predicted the Covid-19 pandemic or other global economic stress factors, and accordingly the impacts that they have had. However, the impact of the pandemic may present some significant challenges for the Council that negatively impact on future cashflows and profitability. There are increased risks of default by tenants on lease payments and the anticipated decrease in demand for office accommodation may have a significant impact on the Council's ability to attract and retain tenants. Whilst we think there may be no immediate concerns for the Council in meeting its loan repayment obligations, this may not be the case in the medium to longer term

Recommendation: The Council should develop its investment property portfolio modelling to bring these in line with the expected practice of an institutional investor. This should include robust stress testing and sensitivity analysis which incorporates scenarios that cover the highest level of risk for expenditure, revenue, tenant behaviour and external socio-economic factors. Consideration should also be given to the diversification of the portfolio and whether this should be addressed over medium to longer term.

6. **Governance issues**

6.1 As stated in 3.2.8, our 2016/17 audit found significant weaknesses in the Council's arrangements to ensure value for money. In particular, we found:

(a) Poor record keeping in relation to the decision-making process.

(b) A lack of clarity around the potential financial impact for the Council if BP were not to renew the lease after 20 years (the length of the lease), in circumstances where the costs of the loan need to be met for 50 years.

6.2 Our review for the processes in place for 2017/18 investment property acquisitions found similar weaknesses as the record keeping remained poor and long-term loans (profiled over a 50-year period) were used to purchase the properties. A key difference for the 2017/18 investment property purchases, is that the lease terms are significantly shorter than the 20-year BP lease.

6.3 By investing a total of more than £1 billion in property (including investment property purchases made after 2017/18) through borrowing, the Council has established itself as an institutional investor

with a large investment portfolio. We recognise that commercial real estate can be an appealing proposition for institutional investors (typically pension and life insurance funds) as it provides long term, and generally stable, income. It is also an avenue to diversify risk as part of a balanced investment portfolio. Generally, commercial real estate is not highly correlated to other asset classes such as cash, fixed income (bonds and gilts) and equities, meaning that property values move independently of the performance of other assets. As such diversification is key in any investment portfolio.

6.4 According to the CFA Institute, as an organisation that seeks to set professional standards for investment management, in their portfolio management guide, institutional investors, including those in commercial real estate, have three distinct stages in portfolio construction and management, namely planning, execution and feedback. Our review found that this process was not followed by the Council. Instead, the process followed was relatively simple in nature and, as highlighted above, lacked any formal documentation of the decision-making process.

6.5 The first step in any investment process is to understand an institutional investor's needs and risk profiles, and then develop an Investment Policy Statement ("IPS") that addresses this. It outlines the rules and guidelines that should be followed when considering asset allocation in the institutional investor's portfolio. An IPS was not formally developed or used by the Council.

6.6 The second stage is execution. In this stage, we would expect the Council to construct a suitable commercial real estate portfolio based on their IPS. This stage consists of deciding on a target asset allocation, which determines the weighting of asset classes included in the portfolio. Good practice would include agreeing on the mix of commercial real estate investment in conjunction with treasury investments to ensure that the portfolio is well balanced. At this stage, investors would also consider macroeconomic and property-specific factors, and the expected level of cash flows from the commercial real estate investments. After this analysis, the investor would then begin purchasing assets in line with their asset allocation, asset analysis and the requirements set out in the IPS. The key objective should be to have a diversified and balanced portfolio. The Council's portfolio is not balanced. It consists only of office accommodation, and the properties are all located in the same geographical area.

6.7 The final stage is the feedback stage. The Council should have detailed the frequency of reporting on commercial real estate portfolio performance to councillors and senior officers before making any acquisitions. The format and content of reporting we have seen as part of our review did not cover all of the areas we would typically expect to see. The areas that we would have expected to be in included in the Council's reporting but were not reported on are:

- Overview of the portfolio
- Portfolio breakdown by Asset, Sector and Region
- Portfolio performance vs the agreed benchmark
- Actual vs target profitability
- Number of properties
- Weighted Average Lease Length
- Net initial yield of the portfolio

- Key risks; and
- Any material changes regarding the properties, tenants or leases.

6.8 There should also be a process for rebalancing the portfolio due to changes in the marketplace and other factors, such as a slump in the commercial real estate sector or changes in demand for office accommodation due to covid-19. Again, we saw no evidence of such a process included in the Council's strategy.

6.9 Based on the information we reviewed, we cannot establish that the Council had appropriate strategy, processes, and governance prior to investing in commercial real estate. Some of the gaps that we have identified include:

- a lack of a defined investment strategy at the time of making the acquisitions. This lack of strategy is also evidenced by the Council purchasing assets where the tenants have different credit profiles;
- while currently each asset *may* appear to be profitable, there is lack of diversification in the investments;
- there is a high asset concentration with four investments exceeding 80% of the value of the portfolio 2017/18, increasing risk in the portfolio;
- there are significant inconsistencies between the time horizon in the financial model (20 years), the debt tenor (50 years) and the leases (<20 years). More than £468m of loans are structured for repayment between 21 and 50 years as at 31 March 2018;
- good practice would have involved constructing a property portfolio in conjunction with the Council's treasury investment portfolio so that risks such as diversification, liquidity, correlation and systematic risk are managed across the whole investment portfolio;
- at the time the acquisitions were made, there was a lack of in-house expertise and investment authorisation processes to invest in commercial real estate; and
- the Council's structure used to deliver/hold the investment properties involves borrowing the funds directly onto its balance sheet and use the proceeds to purchase properties. As such, the Council is exposing itself to debt repayment risk, irrespective of the underlying assets' performance.

6.10 In our view we consider that there are significant failings in the Council's governance arrangements in making these investment purchases. The decision to purchase the 2017/18 investment properties, which has contributed to the Council currently holding a portfolio in excess of £1 billion financed entirely by loans, carries significant inherent risk. In particular, the processes that the Council has followed are poorly documented, do not follow industry expected practice and the people involved in the making decisions at the time of acquisitions lacked relevant experience in making investment property decisions of this nature.

Recommendation: The Council should develop an action plan as part of the management of its investment portfolio which addresses each of the weaknesses identified in paragraph 6.9. This should be linked to a portfolio risk register, which monitors each of the KPIs, tenant performance and risk to the debt repayment strategy for each investment property asset.

7. **Exercise of statutory audit powers**

7.1 As outlined above, we have serious concerns about the lawfulness of the borrowing and investments for the year 2017/18, which the Council does not accept. In other circumstances an application to the Court under section 28 LAAA 2014 for a declaration that the relevant items of account are contrary to law may therefore have been appropriate. LAAA 2014 is clear that applying for a declaration is a discretionary power. In this case, we have decided that on balance a public interest report is more appropriate in circumstances where the Council's commercial property programme has been brought to a close, and the PWLB restrictions will make it more difficult for similar transactions to be made in the future. There is a public interest in clarifying the law in this area, but the financial burden of doing so would fall on the Council's taxpayers. Given the low risk of similar conduct in the future, a declaration does not therefore seem appropriate.

7.2 A public interest report will bring the matter to the public's attention in a formal and comprehensive way: it allows us to record our concerns which go beyond those relating to the lawfulness of the transactions (including the financial issues and governance concerns outlined above). Although there will be no definitive judgment from the Court, LAAA 2014 requires a formal response from the Council on the matters raised in the report. We consider it to be in the public interest that the public and Government are made aware of the relevant issues. The latter is relevant because we hope that this report will contribute to the debate about whether further action is required at a policy level (for example, legislation). We have also considered the relative costs of the two courses of action against the public interest of each. In the circumstances, we have decided that making a public interest report seems a more proportionate way forward.