Eleventh Report of Session 2019-21

Ministry of Housing, Communities and Local Government

Local Authority Investment in Commercial Property

Introduction from the Committee

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

Based on a report by the National Audit Office, the Committee took evidence on 15 May 2020 from the Ministry of Housing and Local Government. The Committee published its report on 13 July 2020. This is the Government response to the Committee's report.

Relevant reports

- NAO report: *Local Authority Investment in Commercial Property* – Session 2019-20 (HC 45)
- PAC report: *Local Authority Investment in Commercial Property* – Session 2019-20 (HC 312)

Government responses to the Committee

1: PAC conclusion: *The Department has been complacent while £7.6 billion of taxpayers' money (including the extra £1bn spent in the first half of 2019–20) has been poured into risky commercial property investments.*

1: PAC recommendation*: The Department must be more active in its oversight of the prudential framework and strike a better balance between supporting localism and ensuring that local authorities act within the frameworks that underpin local freedoms. To do this the Department should:*

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

1.1 The Government agrees with the Committee's recommendation.

Target implementation date: July 2021

1.2 The department is implementing its capital strategy designed to improve government's data, ensure the Prudential Framework is robust and drive sector compliance with the Framework's objectives. As the department implements its strategy, government will reinforce what is, and is not, acceptable within the intent of the Framework. As a first step, the department is considering a range of interventions for addressing instances where there is clear disregard of the Framework's principles. The intent is to provide a spectrum of options from timely engagement and challenge with authorities where issues are identified, to the potential for statutory intervention.

1.3 Sir Tony Redmond's Review of Local Authority Financial Reporting and External Audits was published on 8 September. In responding to the review, the department is reinforcing its message to the sector by clearly setting out the links between its objective to address problematic commercial investment activity and the role of audit, which supports regulation of the Prudential Framework through transparency and accountability.

1.4 As part of the capital data review, the department is engaging with the sector as well as working with key stakeholders, including the Local Government Association (LGA). In so doing, the department is actively communicating government's objective to better constrain excessive risk from local authority commercial activities. Through the review, the department also intends to better understand where authorities find guidance or messaging by regulators unclear and then work with the Chartered Institute of Public Finance & Accountancy (CIPFA), LGA and other relevant stakeholders to address the specific issues.

1.5 Furthermore, the department continues to work with HM Treasury as it implements reforms to the Public Works Loan Board (PWLB), which clearly defines acceptable and unacceptable investment using PWLB loans.

2: PAC conclusion: ***The Department's failure to ensure that authorities adhere to the spirit of the framework has led to some authorities taking on extreme levels of debt which is both risky and sends a mixed message to the sector.***

2.1 The Government notes the Committee's conclusion.

3: PAC conclusion: ***Where a local authority uses prudential borrowing, it must set aside money each year to repay the debt.***

3a: PAC recommendation: ***For its future oversight of the prudential framework the Department needs to develop, and rapidly deploy, interventions that target extreme risk taking. These should be used as part of a wider package of measures to limit non-compliance with the framework, regardless of scale.***

3.1 The Government agrees with the Committee's recommendation.

Target implementation date: July 2021

3.2 The department is aware that some local authorities are not complying with the statutory guidance for Minimum Revenue Provision (MRP). The *Post Implementation Review of Changes to the Local Authority Capital Finance Framework* (April 2019) found examples of deviation from the statutory guidance to be fairly widespread. Common examples included not charging MRP on certain asset types.

3.3 The department is developing options for appropriate levers for intervention ranging from light-touch through to the potential for direct intervention to target all forms of non-compliance. The department recognises that government needs a range of interventions where local authorities are not complying with the Framework and taking on excessive risk. It is important to the department to establish an effective system that addresses current risks but is sufficiently flexible to also address future risks as sector behaviour inevitably evolves. The department also recognises that any system of intervention needs to be proportionate and not cut across the benefits of local decision making. As such, interventions should serve to reinforce, rather than conflict with, the principles of the Prudential Framework.

3.4 In considering the use of interventions, the department is mindful that the *Post Implementation*

Review of Changes to Local Authority Capital Finance Framework found that the majority of local authorities appear to be using the framework sensibly and effectively to support the delivery of policy objectives in their local area.

3b: PAC recommendation: *The Department should undertake a review of the MRP guidance and consider whether its statutory basis should be strengthened and how to require local authorities to improve the clarity and transparency in relation to commercial property purchases.*

3.5 The Government agrees with the Committee's recommendation.

Target implementation date: Summer 2021

3.6 As the Committee will be aware, the department strengthened its Statutory Guidance on Minimum Revenue Provision (MRP), with effect from April 2019. It is now working up proposals to strengthen the application of Minimum Revenue Provision further through Regulations.

3.7 The Department recognises that some local authorities' practices are not in line with the intent of the Framework, as they are either not charging MRP on debt relating to certain investments or the level of MRP is too low. Following the department's investigation in 2019 into MRP practices, it has stated that it will consider, in discussion with CIPFA, whether clarification of the framework is needed to ensure local authorities' practices meet its intent regarding MRP. This work will be taken forward alongside other initiatives to ensure alignment of government's objectives, and clear messaging to the sector.

4: PAC conclusion: *The actions taken by the Department to address risky and non-compliant behavior have been too little and too late.*

4. The Government notes the Committee's conclusion.

5: PAC conclusion: *Taken together these changes represent a significant 'hard' intervention and demonstrate that the 'soft' approach of guidance changes has failed.*

5: PAC recommendation: *The Department should take steps to ensure that future interventions are more timely and effective, and subject to rigorous postimplementation review to ensure lessons are learnt.*

5.1 The Government agrees with the Committee's recommendation.

Target implementation date: December 2021

5.2 The department recognises the importance of evaluating interventions and has conducted a post implementation review of the changes made to the statutory investment guidance. The findings of the review have provided useful insight that has informed the department's current strategy. As discussed in recommendation 2(a), the department is further developing a range of usable interventions that can be applied in a timely manner. Additionally, the data review will ensure that government is sighted on risks earlier allowing for more proactive intervention in future.

5.3 The department remains committed to assessing the impact of its interventions in a timely and robust way. Once it has implemented changes to the Framework, it will conduct evaluations and lessons-learned exercises at an appropriate point. The department intends that the current capital data review will provide a better understanding of sector activity against which the outcome of departmental actions can be assessed.

5.4 On timing, government will only be able to evaluate interventions once the changes are in place and sufficient time has passed for a measurable effect to have occurred. The government does not envisage undertaking any evaluations until 2021.

6: PAC conclusion: ***The prudential framework has been impaired by the emergence of new forms of behavior in the sector, and now requires fundamental review.***

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

6.1 The Government agrees with the Committee's recommendation.

Target implementation date: July 2021

6.2 The department agrees that sector activity has called into question whether the Prudential Framework remains fit for purpose. The department will undertake a number of activities to strengthen the Framework:

- The department is developing options to address specific instances where authorities are not complying with the intent of the Framework, including options for timely intervention.
- The department is undertaking a review to ensure it has the data it needs to understand the trends and drivers of borrowing and investment in the sector, and the associated risks to financial sustainability. This work will also provide an evidence base for further policy decisions. Better data is also needed for government to fully understand the capital system, to ensure future interventions are effective but do not have unintended consequences.
- As set out in the responses to the other recommendations, the department will work with a range of stakeholders, including CIPFA and LGA, to support the delivery of appropriate training, providing clear guidance and to strengthen local governance.

6.3 The department's intention is that the Prudential Framework will continue to allow local authorities to delivery capital strategies that best serve their communities, while ensuring that risk to the local government financial system remains within acceptable limits.

7: PAC conclusion: ***The Department does not have access to the data it needs to carry out its oversight responsibilities properly.***

7. The Government notes the Committee's conclusion.

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

8.1 The Government agrees with the Committee's recommendation.

Target implementation date: September 2020

8.2 As set out, the department is conducting a data review over summer 2020. The initial phase of the review will establish the data and knowledge gap and set about collecting the data needed. As stated above, it is the department's intention that the output from the data review will then inform further policy decisions based on sound evidence. The output will also inform future data collections so that the Department has the data it needs for effective oversight.

8.3 The Department is working closely with CIPFA, HM Treasury and the sector on the review. The department will write to the Commission in September 2020 to provide the Committee with an updated position.

9: PAC conclusion*: Changes to external audit might improve its ability to provide assurance related to local authority commercial investment activity but it will not be a silver bullet.*

9a: PAC recommendation*: As part of its review of the prudential framework, the Department should consider a wider package of changes, rather than relying primarily on (post-Redmond) external audit to address failings in the local governance of commercial investment activities.*

9.1 The Government agrees with the Committee's recommendation.

Target implementation date: July 2021

9.2 The department recognises the importance of external audit for transparency and accountability, and that auditors are important actors in ensuring proper local governance. However, the department agrees that changes to external audit would, in themselves, not resolve the issues raised by the Committee with respect to local authority commercial investment. The department's responses to the other recommendations outline the proposed programme of work.

9b: PAC recommendation*: The Department should write to the Committee within three months of the publication of the Redmond Review setting out its response to the review, including not only how the Department intends to strengthen local audit but also how this will support improved governance of commercial investment activity.*

9.3 The Government agrees with the Committee's recommendation.

Target implementation date: December 2020

9.4 The department will write to the Committee following the publication of the *Review of Local Authority Financial Reporting and External Audits* on this basis. The department is already actively considering the role of external audit in transparency, accountability and driving compliance with the Framework. For example, the department actively engages with the National Audit Office with respect to the Audit Code and associated guidance. The department is considering carefully how the outcomes of the review and the department's response could, alongside other measures, serve to constrain risks and ensure that authorities appropriately comply with the Framework.

10:* PAC conclusion: *Local governance arrangements are not robust enough with some authorities' commercial investments not being properly transparent or subject to adequate scrutiny and challenge.

10: PAC recommendation*: The Department should:*

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

10.1 The Government agrees with the Committee's recommendation.

Target implementation date: July 2021

10.2 The department has taken steps to improve the transparency of capital plans through updating the Statutory Guidance on Local Government Investments in 2018. The changes include the requirement for councils to publish an Investment Strategy on the council's website and the use of indicators to allow members and the public to understand the risk and performance of investments. The department's *Post Implementation Review of Changes to the Local Authority Capital Finance* reported that the introduction of the capital strategy has helped to develop a more focused approach and has been useful in presenting the cumulative impact of decisions to members.

10.3 However, it also reported that there is still progress to be made in terms of transparency and, although there were some excellent examples of this identified as part of the review, this was not wide ranging. Therefore, the department agrees that more could be done to ensure that local authorities are transparent and consistent in the information that they report on the risks and performance of their investments.

10.4 The department intends to use the capital data review to collect evidence on local authority practices for managing, monitoring and reporting performance and risk, and how consistently the sector is complying with guidance. The department will then consider, with relevant partners, what further actions are needed.