Ministry of Housing, Communities & Local Government

Jeremy Pocklington CB
Permanent Secretary

Ministry for Housing, Communities and Local Government
2 Marsham Street
London SW1P 4DF

Tel: 0303 444 2785
PSPerm.Sec@communities.gov.uk
www.gov.uk/mhclg

Dame Meg Hillier MP
Chair of the Public Accounts Committee
Public Accounts Committee,
House of Commons,
London,
SW1A 0AA

17 August 2021

Dear Dame Meg,

ELEVENTH REPORT OF SESSION 2019-21: LOCAL AUTHORITY INVESTMENT IN COMMERCIAL PROPERTY

In the Government's response to the Committee's report *Local Authority Investment in Commercial Property*, the Department agreed with all of the Committee's recommendations and committed to a target date of July 2021 for publishing details on its programme of work to address the weaknesses identified in the local government capital system. On 28 July, Government published an update on the plans and progress it has made in delivering a comprehensive set of actions designed to strengthen its role, both as steward of the local government finance system and the underlying Prudential Framework, as well as in supporting improvements to local regulation and governance. The published document can be found at gov.uk.

Since the Committee's report in summer 2020, the repercussions of the COVID-19 pandemic have exposed further fragilities in the capital system beyond the risks associated with local authority investments in commercial properties, and it is clear that other problematic behaviours also need to be addressed. These include taking on excessive debt, even where the objective is not primarily for yield, and inadequate governance and management of investments that has contributed, in some cases, to financial failure and the need to seek emergency government support.

Government's programme of work is designed to address multiple parts of the capital system, to reduce the range of risks we have identified while preserving the benefits of local decision-making: the main tenet of the prudential system. To be successful, it will work alongside other major programmes of work including the response to the Redmond Review, and improvements to transparency of key metrics and outcomes. For clarity, I include a summary of how the programmes of work meet the recommendations of the Committee's report in **Annex A.**

Yours sincerely,

Jeremy Pocklington

JEREMY POCKLINGTON

ANNEX A

SUMMARY OF PROGRESS IN MEETING THE COMMITTEE'S RECOMMENDATIONS

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.*

On both 6 January and 6 July, the Secretary of State set out in his speeches at conferences organised by the Local Government Association, his expectations for local authority capital investment. He made it clear that councils should not take on excessive debt, become over-reliant on commercial income nor pursue risky investment practices for which they do not have the requisite skills and experience to manage without placing taxpayers' money at excessive risk.

Consistent with Secretary of State's speeches, we have now published our programme of work designed to strengthen the capital system which will serve to reinforce Government's message to the sector and set out clearly the actions Government is taking. In developing and implementing the programme of work, Government has worked closely with sector representatives as well as other key stakeholders including CIPFA, the LGA and the NAO.

The published programme update sets out a range of actions that tackle issues across the whole capital system using a model of 'three lines of control' :

- The first line of control is the scrutiny of local authority activity, enabled by transparency and reporting. This includes effective monitoring by Government and others with a regulatory function, but also ensuring that there is sufficient transparency such that LAs can be held to account locally.
- The second line of control is the system of controls within local authorities. At this level, Government actions can directly address local mismanagement through direct intervention or support strengthening of local authority controls and capability to achieve better outcomes. This aims to strengthen local decision making and risk management by supporting improvements to capability and governance of investment decisions.
- The third line of control is the Prudential Framework itself. It uses the existing statutory powers for intervention, alongside previously unused opportunities to strengthen the Framework

Further, since the Committee's report, Government has been engaging actively with individual local authorities on specific issues. Government's clear messaging on the Prudential Framework has meant that more authorities have pre-emptively sought Government's view on their capital practices, and Government has reiterated what is and is not acceptable. This is proving to be effective for preventing risk entering the system.

Where local authorities have approached government for exceptional financial support, some of the cases have been related to commercial investment. Government has commissioned assurance reviews in 8 councils, the findings of which will provide evidence for understanding the cause of risk and how authorities should address it. In addition, in two councils, Government has appointed an Improvement and Assurance Panel to support and challenge those councils as they address failings that have led to their difficulties and advise the Secretary of State on progress. Both panels include members who provide the Secretary of State with advice on commercial considerations.

2. *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.*

Government is developing a scaled approach to engagement. This ranges from initial engagement and communication with the authority to understand the risk and clarify the Government's stance through to more intensive work such as involvement of auditors.

The reforms to the lending terms of the Public Works Loan Board (PWLB) have been in force since November 2020, and are designed to prevent local authorities borrowing from the PWLB if they intend to invest primarily for yield. MHCLG will soon take on the operational responsibility for reviewing local authorities' three-year capital plans, which they must submit to access the PWLB. This aligns well with improving Government's stewardship: the plans will provide valuable information on planned local authority borrowing, and Government will also use intelligence from its wider monitoring of the sector to determine if local authorities are compliant with the lending terms.

3. *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.*

Government has worked with CIPFA and sector representatives on proposed changes to the regulations and guidance that underpin the Minimum Revenue Provision (MRP) duty, to improve sector compliance. Government is now developing its proposals to ensure they meet the required objective of driving good practice, while avoiding unintended consequences.

Government will therefore consider changes to the Regulations and guidance and plans to consult later in the year. In considering changes, Government needs to appropriately understand the financial impact to the sector and how to mitigate the associated risks to budgets.

Government will engage with the sector to reflect local authority views and to use the opportunity to make clear its expectations. Government recognises that it will also need to support improvements to local authority capability and engage with auditors to ensure that compliance with the MRP duty is robust and consistent across the sector.

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

Government is improving its monitoring of the sector through improved data collection and intelligence gathering. The most recent data already demonstrates that both new borrowing and commercial investment decreased significantly in 2020/21 relative to 2019/20. The advent of Covid-19 has had a significant impact on sector capital activity, and so it is difficult to judge whether the decrease in commercial investment represents a lasting change in sector behaviour. Government will continue to monitor sector trends as recovery takes place to understand whether past problematic trends re-emerge. Government is clear that it will take further steps if needed.

5. *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.*

Government has now published its progress report that sets out the actions it is taking to ensure the risks identified by the Committee are addressed, as well as the additional issues that have come to light over the past 12 months. In reviewing the capital system, Government has drawn on the evidence from the NAO and Committee reports, its continued monitoring of sector data and sector engagement, and evidence that has come to light from those authorities that have approached Government for emergency financial support.

Further, Government has worked closely with key stakeholders CIPFA, the LGA and sector representatives, and engaged with the NAO to ensure that its approach is robust and addresses the risks and issues identified. This has been reflected in designing and implementing the range of actions set out in the progress report, which take a holistic approach to strengthening the system at multiple points using the ‘three lines of control’ model, set out above: detection of risks through scrutiny and transparency; processes at local level over decisions making and risk management; and, the Prudential Framework itself.

In response to the Committee's recommendations, CIPFA has recently concluded the first consultations on amendments to its statutory codes: the Prudential Code and Treasury Management Code,. Local authorities are required to have regard to these codes of practice. Government has worked closely with CIPFA in developing the amendments. The amendments provide greater clarity to the sector and additional guidance on managing risk. The second set of consultations, on the new draft Codes, are scheduled to be launched in August, with implementation from April 2022.

6. *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.*

This recommendation has been completed. Government wrote to the Committee last year to set out its plans for improving its data. Government has now completed the voluntary data survey to gather additional information on sector behaviour and is now using the findings to implement permanent changes to its regular data collection from February 2022.

Government is also improving its early identification of risk, by developing additional metrics to use our data and qualitative information in a tool for the earlier identification of risky capital practices. This will be used alongside targeted engagement to address risk and non-compliance in a more timely way. Government is continuously improving the analysis it undertakes to monitor the sector and is using the information collected from local authorities that have experienced financial failure as evidence for the indicators it needs to monitor.

Lastly, local authorities are now required to submit three-year capital spending and borrowing plans in order to access the PWLB. Government is reviewing all submitted plans. The new information provides a valuable source of advance information.

7. *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.*

The role of audit is important for scrutiny and transparency, and we have seen a number of recent examples of auditors identifying issues, including those concerned with capital activity, through public interest reports, leading to Government intervention. However, Government is clear that external audit is just one part of a broader governance and accountability framework for local government.. Government has set out its 'three lines of control' that underpins a broad range of work to tackle risks at different parts of the system.

8. *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.*

This recommendation has been completed. Government published its response to the Redmond Review on 19 December 2020, and a further report, setting out its response to outstanding recommendations on 20 May. Government is committed to shortly publishing a consultation setting out its proposals for implementing many elements of the review, and is committed to writing to the PAC outlining progress against a number of recommendations following the recent PAC inquiry into local audit timeliness by September 2021.

9. *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.*

Government is currently commissioning a review of governance and capability of investment decision-making and management in local government. The review will have two stages, the first stage being a landscape review to identify the key systemic issues and failures, and the second stage to commission guidance and training targeted at the areas that need the most improvement. The first stage is planned to be completed by the end of 2021, and the second stage to be implemented in early 2022.

Government is working with CIPFA on the revised Prudential and Treasury Management Codes, which provide greater clarity and additional metrics and guidance on managing risk, and will consider the need to review its own guidance once this work has concluded.