Ministry of Housing,
Communities &
Local Government

Post Implementation Review of Changes to the Local Authority Capital Finance Framework

Local Government Finance

April 2020
Ministry of Housing, Communities and Local Government

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Summary

Background

1. Councils have had the flexibility to borrow in sterling and invest in any asset class without government consent since the introduction of the existing framework for capital finance in 2004.

2. In exercising these freedoms, local authorities are required to have regard for the following statutory codes issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Ministry of Housing, Communities and Local Government (MHCLG, the Department):

   - The Prudential Code for Capital Finance in Local Authorities (CIPFA)
   - Treasury Management in the Public Services Code of Practice (CIPFA)
   - Statutory Guidance on Local Government Investments 3rd Edition (MHCLG)
   - Statutory Guidance on Minimum Revenue Provision 4th Edition (MHCLG)

3. These documents were updated in 2018 in response to changes observed in patterns of local authority behaviour, specifically, an increase in borrowing and investment activity. Councils are increasingly investing in non-financial assets with the primary or partial aim of generating profit to supplement their revenue budgets. Some authorities are also entering into very long-term investments or providing loans to local enterprises, third sector entities and wholly owned companies or associates as part of regeneration or economic growth projects that are in line with their wider role as a place-maker.

Policy objectives of the changes to the guidance

4. The overarching objective was to ensure that the control system for local authority borrowing and investment activity remained sufficiently robust and relevant to the current landscape. Specifically, the changes were designed to address the following concerns:

   - Local authorities are exposing themselves to too much financial risk through borrowing and investment decisions.
   - There is not enough transparency to understand the exposure that local authorities have as a result of borrowing and investment decisions.
   - Members and decision-makers are not equipped with sufficient expertise to understand the complex transactions that they have ultimate responsibility for approving.

5. The prudential framework is a principles-based system. Its primary purpose is not to act as a control on the amount of borrowing but on the assessments of risk

and affordability used to inform borrowing and investment decisions. The changes to the framework were designed to strengthen these arrangements, rather than to act as a measure to reduce or restrict local authority borrowing activity.

Guidance changes

6. The changes introduced to the existing framework were:

- A new requirement for councils to prepare an investment strategy and a capital strategy annually.
- A required disclosure around the contribution that investments make to service delivery.
- Quantitative indicators to be included in order to enable decision makers and members of the public to understand the performance of and risks associated with investment activity (these indicators are not prescribed although some suggestions are included with the guidance).
- An extension of the requirements on capacity and skills to members and any statutory officers involved in or responsible for signing off on investment decisions.
- Clarification around borrowing in advance of need.
- Removal of flexibility to charge negative minimum revenue provision (MRP).
- Introduction of a maximum economic life for assets in assessing MRP.

7. Local authorities were required to incorporate the new guidance into their strategies from 2019/20 (although some councils opted to amend their 2018/19 strategies for this).

Purpose and scope of the post implementation review

8. This post implementation review was designed as an impact evaluation, with the aim of establishing:

a) The extent to which the changes have been successful in ensuring that local authority borrowing, and investment activity remains prudent and affordable;

b) What impact the changes have had on decision making and transparency;

c) The level of assurance that can be derived from the approaches that local authorities are adopting towards balancing risk against reward;

d) Whether decision makers and relevant statutory officers feel adequately equipped to make judgements on what is prudent and affordable; and

e) The role of audit and how this may be developed.

9. Further changes to the capital finance framework were not the objective of this review. However, the findings may be used to help inform any future considerations.

Key findings

10. Based on local authority surveys and discussions, the majority appear to be using the framework sensibly and effectively to support the delivery of policy objectives in their local area.

11. Feedback received as part of this review indicates that the introduction of the capital strategy has helped to develop a more focused approach, and that it had been useful in presenting the cumulative impact of decisions to members. 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 is not currently wide ranging.

12. The understanding of decision makers continues to be a risk; around a third of respondents to the poll rated elected members' understanding of borrowing and investment decisions as 5 out of 10 or lower. Furthermore, 10% of respondents indicated that they considered that the understanding of senior officers was below average.

13. A recurring theme in the discussions with finance officers was the importance of simplicity in the presentation of information as being key to transparency and ensuring that decision makers are adequately equipped to act on an informed basis.

14. The view of respondents is that the existing framework places reliance on local authorities to comply with the spirit of the guidance. Respondents also highlighted their concerns that attempting to place further constraints on local authority investment and borrowing activity could be restrictive and potentially risk impeding the delivery of wider policy objects such as improving housing supply and growing the business rates base. Feedback from roundtable participants suggested they did not want the framework to be redesigned due to the actions of a small number of outliers.

15. The notion of affordability has become less relevant given the recent trend towards yield-bearing investments, and this has resulted in the affordable borrowing limit no longer acting as a true limit.

16. There is an increasing pattern of activities which could be viewed as commercial which may fall outside the remit of the capital finance framework for local authorities. Examples include the use of limited companies to develop or acquire property and income strip deals for regeneration projects. Often these arrangements will have similar objectives to those traditionally fulfilled through direct capital investment by the local authority. Since these arrangements still have the potential to carry significant risks for local authorities, it is important to ensure that there is an effective framework of governance in place for these delivery models.

17. Local authorities will often make yield bearing investments with the intention of pursuing one of their strategic objectives as a place-maker, for example contributing to housing supply in their area, town centre regeneration, or to create or safeguard jobs locally. Because of this, the required disclosures around contribution and proportionality do not have much significance on their own, with many local authorities disclosing that most or all of their planned investment activity made a direct contribution to service delivery. However, the following ratios were found to be useful indicators of proportionality:

    - Ratio of financing costs to net service expenditure (general fund)
    - Ratio of commercial income to net service expenditure

18. Finance officers are concerned that any future constraining measures introduced to the capital finance system could impede the delivery of wider policy objectives relating to housing and regeneration, and inhibit growth in the Council Tax and businesses rates.

19. Based on the evidence collected from authorities during this review, external audit should not be overly relied on as a preventative control to mitigate excessively risky activity. Although the work of external auditors can provide an insight into the governance arrangements regarding particular decisions, detect weaknesses and make recommendations for improvement, the retrospective nature of external audit work means that it is unlikely to inform decision-making at strategy stage and consequently it should not be viewed as a strategy for mitigating risk within the system.

20. It is difficult to establish what might have happened had the changes not been implemented. However, the changes were not designed with a view to revolutionising the system, so the fact that strategies do not appear to have been dramatically transformed does not in itself indicate the impact that the changes have had.

Next Steps

21. As stated elsewhere in this report, further changes to the local authority capital finance framework were not one of the objectives of this review. The framework will continue to be monitored in its current form and these findings may be used to inform any future changes to the capital finance framework and interrelated policy areas.

22. A series of next steps arise from the specific findings identified as part of this review. These are set out below. It is anticipated that some of the findings may be addressed or partially addressed through existing workstreams. Where this is the case, the review findings will be used to inform developments which arise from these workstreams.

The wider prudential framework

23. The Department will continue to carefully monitor the borrowing and commercial investment trends in the sector and the impact on sector sustainability. The Department will carefully consider, with HM Treasury, what additional interventions are required if individual local authorities continue to disproportionately borrow and expose themselves to undue levels of risk. The Department will review its data needs to ensure it understands the trends and drivers of capital investment in the sector, and the associated risks to financial sustainability.

Improving transparency

24. The Department will consider steps to reinforce the importance of transparency, and the requirement for investment strategies to be published and clearly signposted on council websites, in order to ensure that the information is accessible to members of the public. This might be achieved through formal communication from the Department to local authorities initially.

Supporting decision makers

25. The Department will, alongside its partners, consider the need to strengthen the arrangements in place that support the professional development of elected members. In addition to training, consideration will also be given to developing resources which enable decision makers to understand how the quality of decision-making and challenge and investment/borrowing risk profile of their authority compares to that of their peers.

External audit

26. As part of our ongoing work on audit, the Department will consider whether or not the external audit framework could deliver more specific assurance in relation to compliance with the prudential framework, for example, through the VFM conclusion. The Department will also consider introducing a mandatory requirement for all councils to have audit committees, and an obligation to appoint independent members to these committees. We will consider these options in light of the findings and outcomes of Sir Tony Redmond's *Review of local authority financial reporting and external audit* and the implementation of the new National Audit Office *Code of Audit Practice*, which takes effect from 1 April 2020. This new code proposes changes in the way that the VFM conclusion is presented and will be supported by more detailed guidance notes to be developed over the summer.

Methodology

Evidence used to inform the post implementation review

27. Evidence was gathered from a number of difference sources and used to help inform the conclusions of the review. Although the scale of commercial investment activity which provided the impetus for the review of the framework

was concentrated within a minority of local authorities, the review sought to establish the impact of the changes across the whole sector rather than focusing solely on outliers. Therefore, evidence has been considered from a combination of different sources, encompassing a range of different risk appetites.

28. It is important to acknowledge that 2019/20 is the first year that all councils will have prepared their capital and investment strategies under the revised framework in assessing the impact which has arisen from the changes. Some of the desired outcomes, such as achieving greater transparency and upskilling decision makers may require cultural change, and it is quite possible that these changes will not yet be fully embedded. Where this is the case, it would not be reasonable to automatically conclude that the revisions to the framework had been unsuccessful in meeting their goals, but the review will seek to understand the steps that local authorities have taken towards implementing the changes.

29. The following sources of evidence were considered as part of the review:

Strategy Review

- A sample of 2019-20 capital and investment strategies prepared under the revised framework was selected to form the subject of a desktop review. This review aimed to establish how local authorities had incorporated the changes to the framework into their strategic planning and governance processes.
- The sample comprised some strategies selected on the basis of potential risk factors using government data on capital investment, borrowing and commercial income streams. Other strategies were selected at random, covering English local authorities of all classes, from all regions.

Roundtables

- Officials conducted a series of regional roundtable discussions with local authority finance officers, the Local Government Association (LGA), CIPFA, and CIPFA's Treasury and Capital Management Panel.
- These sessions covered targeted questions around three key themes: transparency and decision making, risk and minimum revenue provision as well as a general discussion on the impact of the changes.
- Eight roundtable events were held across the following regions: London & South East, South Coast, South West, Midlands, East of England, North East, North West and Yorkshire & The Humber.
- Participants from all classes of authority were invited to attend, the aim of reaching a cross section of different approaches to implementing the changes, with varying risk appetites.
- In total, through the roundtable discussions, 83 participants from 65 different organisations were engaged with. A full list of the authorities who participated in this aspect of the review has been included within the acknowledgements section at the end of this report. **Figures 1** and **2**

below illustrates the composition of the stakeholder groups consulted through the roundtable discussions.

Figure 1: table showing roundtable attendance by type of authority

Roundtable attendance by type	
London Borough	7%
Shire County	16%
Unitary Authority	36%
Shire District	13%
Metropolitan District	22%
Other	6%

Figure 1 : table showing roundtable attendance by region

Roundtable attendance by region	
London	8%
South West	11%
North West	17%
East Midlands	7%
East of England	11%
South East	13%
North East	11%
West Midlands	7%
Yorkshire & The Humber	11%
N/A	4%

Polls

- Supplementing the roundtable discussions, an anonymous poll of invitees was conducted to further develop understanding around the themes of transparency and decision making, risk and minimum revenue provision. Questions were designed to gather the views of senior finance officers on the effectiveness of the framework at local authority level, and the practical application of the statutory guidance documents.
- There was no equivalent poll conducted prior to the introduction of the revised framework, therefore it was not possible to measure the results against baseline data as part of the post implementation review. However,

responses have been incorporated into the findings set out in this report and used inform the overall judgements made in these areas.

- The poll also presented respondents with the opportunity to provide anonymous feedback for consideration by officials.

Consultation with external auditors

- In order to understand the role of external audit, and where this sits as a control within the overall framework governing local authority borrowing and investment activity, the views of local authority auditors were sought via the Technical Network convened by the National Audit Office (NAO) Local Audit Code Team.
- A sample of ISA260 reports (the auditor's report to those charged with governance) and audit plans was also reviewed alongside the investment strategies, in order to establish the extent to which the work of external audit focuses on borrowing and investment activity.

Consideration of Departmental analysis

- The updates to the capital finance framework did not seek to pursue any quantitative objectives, however, reference has been made to statistics and analytical data held by the Department in forming conclusions on the overall impact of the changes.

Findings from the review

1. Transparency

1.1 One of the objectives in implementing the new guidance was to address the concern that there is not enough transparency to understand the risk-exposure that local authorities have as a result of borrowing and investment decisions. The post implementation review therefore sought to establish the impact of the changes on transparency.

1.2 The informal commentary on the statutory guidance on local authority investments states the following:

"The Government believes that local authorities need to be better at explaining 'why' not just 'what' they are doing with their investment activity. That means that the sector needs to demonstrate more transparency and openness and to make it easier for informed observers to understand how good governance and democratic accountability have been exercised."

1.3 Specifically, the changes to the guidance introduced a series of additional disclosures required to be included in a single document presented to full council (or equivalent) for approval, with an allowance for some local flexibility in precisely where and how the required disclosures were presented.

> "The changes have enhanced the importance of capital and investment decisions and encouraged an increased focus on safeguarding property assets and local regeneration."

1.4 The strategy review highlighted that there are significant variations in the extent to which different authorities are achieving transparency in the presentation of capital and investment strategies.

1.5 The potential barriers to transparency identified through the review of information available on the external websites of a sample of authorities are summarised below:

a. **Lack of accessibility** - Lots of strategies can only be found if you know where to look for them within agenda papers. We would regard good practice as being that strategies are published and clearly signposted on council websites, so as to ensure that the information is accessible to interested members of the public.

b. **Lack of prominence** - Linked to the point above, some strategies were found to lack sufficient prominence within the agenda papers themselves, particularly when presented to council for approval. Inevitably, the papers will be presented either as part of, or alongside, the revenue budget and council tax setting papers which have historically received greater focus. However, given the potential scale of risk and long-term nature of capital investment decisions, it is vital that these strategies are given equal status in the decision making process.

c. **Complexity** - The technical nature of the subject matter can result in the content of the strategies being inaccessible to non-experts. The strategy review identified that some local authorities had taken some very positive steps to overcoming this, either through a simplified presentation of key facts and risks or through tailored FAQs designed to convey information to non-experts. Some stakeholders also commented that the fragmented nature of the guidance in this area serves to increase the complexity of the documents which councils are required to produce.

> "The changes have not had any significant impact locally, although the capital strategy has helped to bring things together."

d. **Length** - there was a notable variation in the length of strategies between different local authorities. Feedback received as part of the roundtables suggested that extensive disclosure requirements sometimes served to obscure the key messages. Based on feedback received from finance officers, the most effective strategies tend to be principles based, drawing out the key messages only, and consequently tend to be brief (not more than four pages). As members are more inclined to engage with specific decisions within the strategy, rather than the strategy itself, there is scope to include further detail at that stage.

e. **Decisions taken in private** - the majority of commercial investment decisions are taken in private. Councils are able to restrict publication of agenda papers prior to the meeting and exclude the press and public from the meetings if it is likely that the discussion will involve 'exempt information of the description contained in that paragraph of Schedule 12A of the Local Government Act 1972' and they can demonstrate that it is in the public interest to follow this course of action. This is justifiable, in the context of commercial sensitivity or the disclosure of information relating to a business or an individual. However, the impact of this is that the public are not given the opportunity to scrutinise or comment on decisions until it is too late for them to have any impact.

1.6 Feedback from local authorities through roundtable discussions elicited some positive responses regarding the impact of the changes to the framework on transparency. Most commonly, participants commented that the introduction of the capital strategy which brought together different components into a single place helped to convey the impact of decisions and associated risks more clearly to members.

1.7 However, some local authorities responded to say that the impact of the changes had been minimal as they felt that the revised framework did not introduce a significantly different approach to the one which they already had in place.

1.8 The *Statutory Guidance on Local Government Investments* makes reference to the public and local residents in the context of transparency and democratic accountability. This presents one of the most significant challenges, with the majority of local authorities reporting they receive limited or no engagement from local residents on their investment and borrowing activity.

Conclusions

1.9 Overall, feedback points to the fact that the introduction of the requirement to produce a capital strategy has had some positive impacts on transparency, in bringing together different aspects of strategic planning and presenting the cumulative impact of decisions in one place.

1.10 However, there is still significant progress to be made in terms of transparency and although there were some excellent examples identified in the review, this is not currently wide ranging. Given the importance of transparency to effective governance, it is crucial that local authorities prioritise this.

1.11 It is possible that the different sources of guidance issued by the Department and CIPFA present a risk that the framework could appear fragmented, and increases the burden on local authorities to read and have regard for multiple sources of information, which could inhibit the transparency of the strategies which are produced on the basis of this guidance.

Examples of good practice

1.12 Included below are some examples of good practice in relation to meeting transparency objectives identified as part of the strategy review:

- 1.1. A council has included a section on their external website which seeks to set out the background, rationale and risk management arrangements regarding the council's Investment and Regeneration Strategy. The information is presented using language that would be comprehensible to a non-expert, and addresses questions such as how risks are managed, whether or not the council has the expertise to execute the strategy and how progress is monitored.
- 1.2. Another council's treasury management strategy draws out 'Facts At A Glance' for investment and borrowing activity, enabling decision makers to quickly grasp pertinent information regarding the proposed strategy, rather than needing to unravel this from the detail. The strategy is also quite clearly tailored to fit the council's plans, as opposed to being structured around a standard template.

2. Governance and Decision Making

2.1 The revisions to the guidance were designed to help mitigate the risk (or perceived risk) that elected members and decision makers were not equipped with sufficient expertise to understand the complex transactions that they have ultimate responsibility for approving. Focal points for this review therefore included understanding the impact of the changes to the framework on decision making, and whether decision makers and relevant statutory officers are equipped with the necessary skills to make informed judgements on investment and borrowing decisions.

2.2 The revision to the investment guidance extended the requirements on capacity and skills to members and statutory officers involved in signing off on investment decisions. This would not necessarily be expected to take the form of professional training or qualifications and could be achieved through a presentation setting out the risks and opportunities of the investment strategy or a specific investment, in terms that a layperson would understand.

"The Strategy should disclose the steps taken to ensure that those elected members and statutory officers involved in the investments decision making process have appropriate capacity, skills and information to enable them to take informed decisions as to whether to enter into a specific investment, to assess individual assessments in the context of the strategic objectives and risk profile of the local authority and to enable them to understand how the quantum of these decisions have changed the overall risk exposure of the local authority."

2.3 The desktop review found that the majority of strategies referred, to a greater or lesser extent, to the qualifications and experience of senior officers and the approach to training members responsible for approving the strategy. Commonly, delivery of member training is through a combination of external advisors and internal briefings and although members are encouraged to attend, training in this area would not be mandatory in order to serve on a certain committee. Finance officers who attended the roundtables were generally satisfied with the quality of the training, although some commented that these sessions are not always well attended by members. Roundtable participants commented that they had always sought to engage members in this way, and it did not appear that the changes to the framework had affected significant change in the procedures which local authorities put in place to equip members with the capacity, skills and information to make informed decisions.

2.4 Despite this, the understanding of decision makers does continue to present a risk with around a third of respondents to the poll rating elected members' understanding of borrowing and investment decisions as 5 out of 10 or lower. Furthermore, 10 per cent of respondents indicated that they considered that the understanding of senior officers was below average.

This matter was explored with senior finance officers who attended the roundtable discussions. The responses were mixed and, as might be expected, the degree of variation between different authorities in terms of quality of decision making and governance processes is significant. The selection of comments shown at **Figure 3** reflects the range of differing responses received when the topic of member engagement in investment and borrowing decisions was explored with senior finance officers.

Figure 3: Feedback from senior finance officers regarding member engagement

"Members need to think longer term in order to make good decisions"

"Having independent members on the Audit Committee has improved the quality of debate"

"Lots of our members are from business backgrounds and they have a really good understanding of our investment strategy"

"Member understanding of the strategies is extremely varied"

"It is important to ensure that you have the right members on the right committees"

"Members tend to be more engaged with individual decisions, rather than the overall strategy"

"We need to rethink the current approach to training members"

"Members' understanding of the indicators is low, and they do not receive much attention"

"Members rely on the knowledge and views of officers"

2.5 It is apparent that, while member engagement with the investment strategy is reported as a strength at some authorities, more commonly this continues to be a challenge. In addition to overcoming the complex nature of the subject matter, a key barrier to engagement was often cited as the long term nature of investment strategies, with members being more inclined to focus on shorter term impacts.

2.6 Notably, there appeared to be a link between reportedly high member engagement with the investment strategy, and a higher risk appetite, with some of the most ambitious strategies appearing to be led by members. Conversely, other local authorities commented that they do not have the in-house expertise to engage in commercial investment activity, and therefore are not adopting this as part of their strategies. It is also common for councils to engage external advisors on specific decisions, and triangulate this with local knowledge as part of the due diligence process for investment decisions.

2.7 It is generally accepted that not all members will have a detailed understanding of borrowing and investments, and it would not be realistic to expect this. Instead, some councils have implemented smaller group or sub-committee of members equipped with the skills to provide scrutiny and challenge specifically on investment and borrowing decisions. Where this committee or group works effectively, officers consider it to be a key driver of good governance.

2.8 Some local authorities had found that use of independent members, particularly on audit committees, had improved the quality of debate and the overall effectiveness of the committee. The challenge of recruiting suitably skilled individuals was recognised, although not universally.

Conclusions

2.9 The changes to the framework do not appear to have had a significant impact on the effectiveness of governance processes, nor the approach to building the capacity and skills of decision makers.

2.10 However, prior to the introduction of the changes to the framework, some local authorities had already taken steps to ensure that robust governance procedures were in place, proportionate to the scale of planned investment activity.

2.11 The importance of member engagement is recognised by finance officers. The election cycle is sometimes seen to present a barrier to long term decision making.

Next steps

2.12 The Department will work with its partners to identify ways to strengthen the arrangements in place to support the professional development of elected members. In addition to training, consideration will also be given to developing resources which enable decision makers to understand how the quality of decision making and challenge and investment and borrowing risk profile of their authority compares to that of their peers.

2.13 Whilst the Department recognises that there are some shortcomings around current audit committee arrangements, such matters are likely to be included within the recommendations of Sir Tony Redmond's review of local authority financial reporting and external audit, which is due to report later this year. The department will therefore consider what changes should be made to the local audit framework once that report is received.

Examples of good practice

2.14 Some local authorities have designed governance processes to enhance decision making and accountability in the delivery of their capital and investment strategies. Often this takes the form of a dedicated committee or group of members whose role is to focus on investment and borrowing decisions, thereby ensuring that there is a mechanism through which decisions can be scrutinised by members with the appropriate skills and understanding.

2.15 Local authorities using independent members have commented that this has been a useful way of introducing specific skills and experience, and bolstering the capacity of committees to provide robust challenge to proposals.

2.16 Some local authorities are also using skills audits to identify gaps and inform the training they provide to members.

3. Prudence and Affordability

3.1. The post implementation review considered the extent to which the changes had been successful in ensuring that local authority borrowing and investment activity remain prudent and affordable. These concepts are central to the capital finance framework, but contain significant scope for subjectivity and judgement.

3.2. Many local authorities have adopted deliberate strategies to subsidise spending on service delivery through commercial income streams, in response to reductions in the funding which they receive through the finance settlement. There are specific powers available to local authorities which enable them to do this, which local authorities say have helped to limit the extent to which reductions in core services have been required, and enabled some discretionary services to be maintained. However, given the emerging pattern of commercial investments financed through external debt, it is necessary to seek assurance that investment decisions being made by local authorities are prudent, affordable and sustainable.

3.3. The practice of local authority investment and borrowing activity which could objectively be judged as disproportionate to the size of the authority is not thought to be widespread. This is reflected in both the findings of the strategy review, and through roundtable discussions. Consequently, the impact of the changes to the framework has not been particularly prevalent in terms of influencing strategic direction.

3.4. Historically, the principle of affordability has acted as a control on the overall level of borrowing that local authorities could take on due to constraints within the revenue account. However, the recent trend towards yield bearing investments has resulted in the notion of affordability becoming less relevant since it is assumed that these capital investments will not result in a net cost to the revenue account (and in some cases, may generate a positive return). As a consequence, the affordable borrowing limit is no longer acting as a true limit.

3.5. The changes were not designed with a view to restricting the level of borrowing across the local government sector, however the guidance made clear the Government's intention to discourage borrowing which is purely for speculative purposes.

3.6. Based on the review of strategies and current projections, borrowing requirements are anticipated to continue to rise. Specifically, spending on trading services, which includes commercial activity, provisionally fell from £3.0bn in 2017/18 to £2.5bn in 2018/19, but is forecast to increase to £4.2bn in 2019/20. [1]

3.7. This forecast increase for 2019/20 is a possible indicator that the changes to the framework have not discouraged local authorities from commercial investment

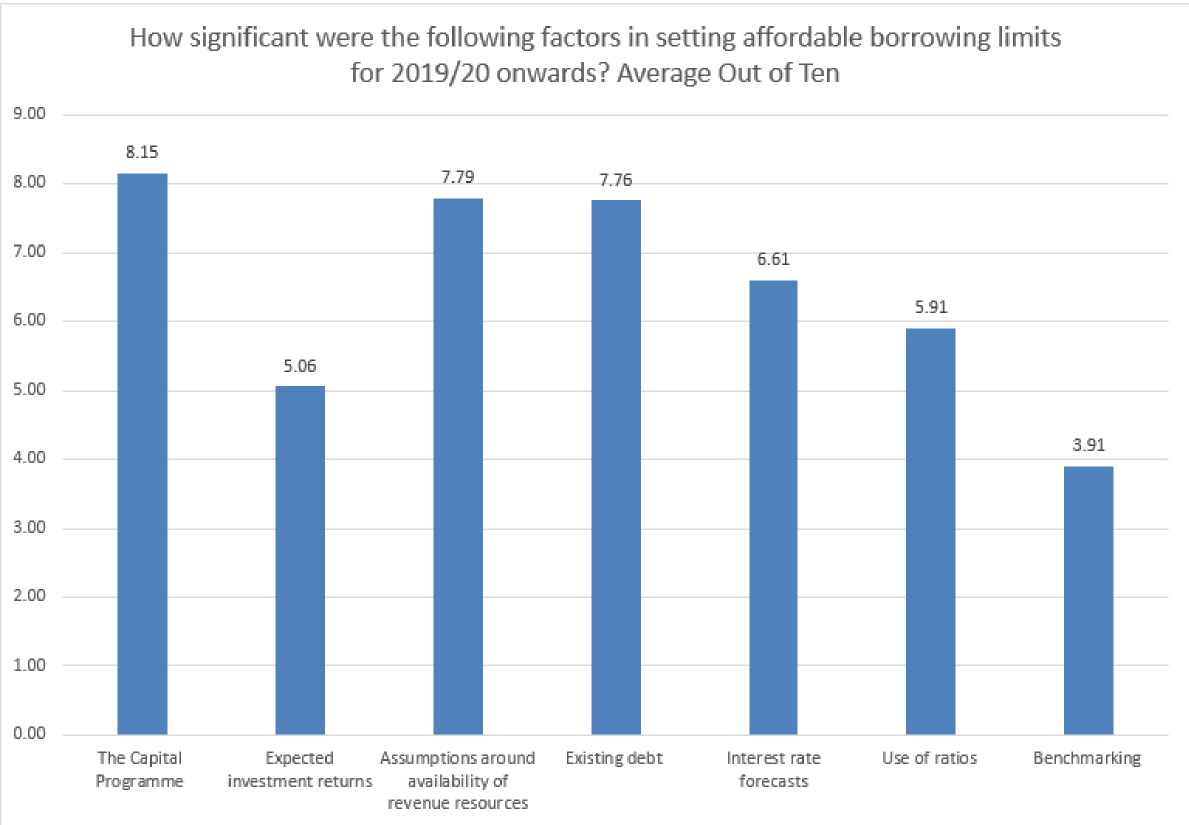
[1] Ministry of Housing, Communities & Local Government. 2019. *Local authority capital expenditure and receipts, England: provisional outturn, April 2018 to March 2019 & forecast, April 2019 to March 2020.* London: Local Government Finance Statistical Release

activity. However, an increased focus on housing development reflecting an alignment with strategic priorities was observed within 2019/20 strategies. It has not been possible to establish whether or not this reflects the impact of updated investment guidance.

3.8. A key line of enquiry for this review was the approaches which local authorities are taking to setting affordable borrowing limits. This self-imposed limit is considered to be an important control in ensuring that prudent decisions are taken for investments financed through borrowing.

3.9. The approach to determining an appropriate limit was discussed with roundtable participants, with the majority commenting that the most common driver tends to be the demands of the capital programme. In this respect it does not represent a true limit (in terms of the maximum amount that is affordable), and can be revisited and amended at any point during the year. However, councils feel that they are prudent in determining what is affordable. **Figure 4** below details some of the most common factors which drive this decision.

Figure 4: Factors driving affordable borrowing limits, 10 = very significant 1= not at all significant



3.10. Feedback from finance officers has highlighted the challenges in properly assessing the level of investment which may be affordable in years to come, given the current uncertainty around the future of revenue funding for local authorities. Given the inherently long-term nature of capital investment and borrowing activity, this uncertainty in future revenue funding inevitably creates a significant degree of risk for local authorities making assessments on funding positions which may be subject to change. Moreover, some local authorities have said that they are turning to commercial income generation in order to introduce a greater degree of stability to their funding streams.

3.11. Affordability may also be impacted by rising costs in other areas which could make borrowing unaffordable. Local authorities keep this under review as part of their budget monitoring, and consequently, the determination of the level of borrowing which is judged to be affordable can change during the course of the year.

3.12. Assumptions around returns from yield-bearing investments are varied. Many local authorities pointed out that they do not build any assumptions around investment returns into their medium term financial strategies. It seems to be generally accepted that, as part of the investment appraisal, a decision would be taken around the capacity of an investment to service debt repayment costs and this would be reflected accordingly in the budget.

3.13. The existing framework is considered by finance officers to be effective. Local authorities welcome the freedoms that it permits them, and they believe that it encourages a prudent approach to borrowing and investment.

3.14. There is a feeling across the sector that these freedoms are being abused by a small number of local authorities. A number of respondents commented that these matters should be addressed on an individual basis, and not in a way which penalises the whole sector.

3.15. The guidance does not define precisely what is meant by ‘too much financial risk’. We received mixed feedback on this matter through our engagement with local authorities, although the overarching sentiment was that this is a judgement that should be made locally. This accords with the principles of the current system as a ‘permissive’ framework and a principles based system.

Minimum Revenue Provision

3.16. Minimum Revenue Provision (MRP) is the statutory charge which a local authority is required to make to its revenue account each year for the repayment of borrowing used to finance capital expenditure. This ensures that the authority is able to pay off its debts as they fall due and is central to the capital finance framework. Local authorities are required to set aside revenue resources to meet the MRP, and consequently the balanced budget requirement acts as the fundamental control mechanism to ensure that debt servicing costs will be met from available resources on an annual basis.

3.17. Prudence is a key concept, with regulations requiring a local authority to prepare a statement of its policy on making MRP in respect of that financial year and submit it to full council (or equivalent) for approval. The statement should describe how the local authority proposes to discharge the duty to make prudent MRP during that year. The statutory guidance was updated in 2018, with local authorities being required to incorporate the changes into their policies from April 2019 onwards.

3.18. The review of MRP policies found examples of deviation from the statutory guidance to be fairly widespread. Common examples included:

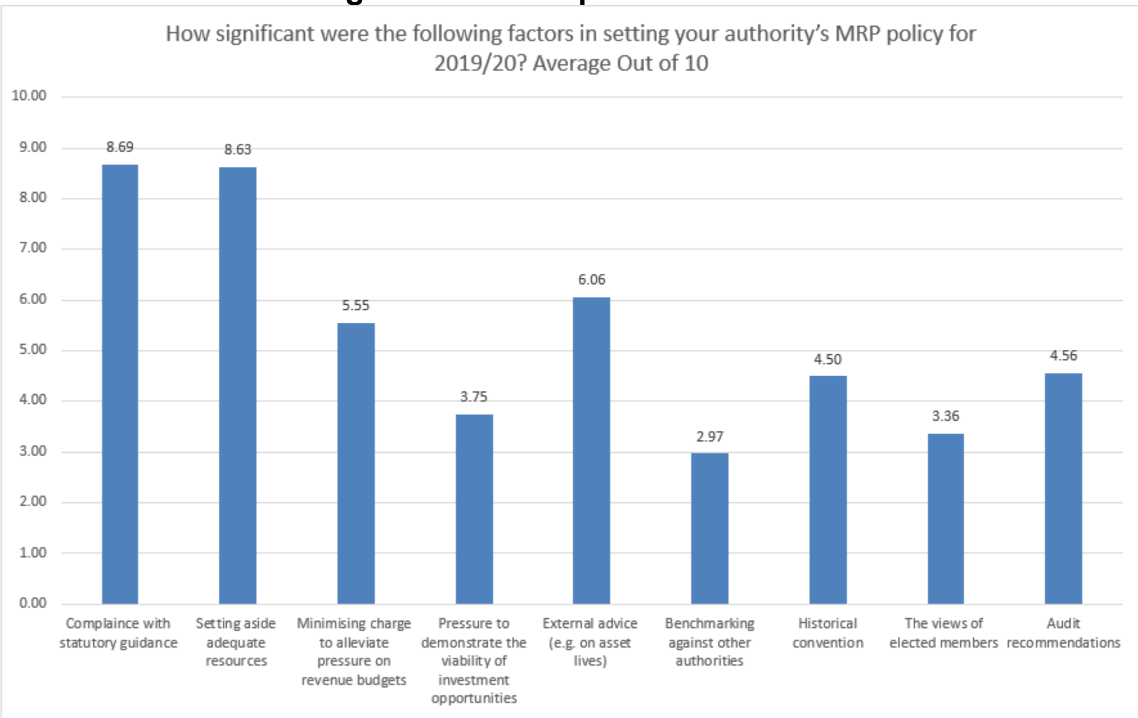
- Useful lives exceeding the recommended maximums included in the guidance.
- Not charging MRP on investment properties, generally on the assumption that disposal of the asset at a point in the future would yield sufficient capital receipts to repay the debt.
- Not charging MRP on capital loans financed through borrowing, on the grounds that repayment instalments will be set aside to finance the local authority's debt liability.
- Not charging MRP on operational assets which form part of a holding strategy which involves disposal of the asset at a point in the future (which would be expected to yield a capital receipt sufficient to repay borrowing).

3.19. This matter was explored with roundtable participants, who were asked:

- What are the factors driving your policy?
- What is your approach to determining a 'prudent' provision?
- Is the guidance useful / fit for purpose?

3.20. Survey participants were also asked to disclose the significant factors influencing their authority's 2019/20 MRP policy. Responses have been summarised in the **Figure 5** below:

Figure 5: Factors influencing 2019/20 MRP policies



3.21. A potentially concerning observation from these results is that some local authorities have cited pressure on revenue budgets as a factor driving their policies. Whilst it is important to acknowledge the risks of maintaining an overly prudent provision and thereby placing unnecessary additional constraints on revenue budgets, it is equally crucial that pressure on revenue budgets does not compromise the requirement to ensure that the provision is prudent and that the local authority will have sufficient resources set aside to repay borrowing.

Over half of the survey respondents indicated that minimising pressure on revenue budgets was a significant factor in setting their authority's MRP policy for 2019/20.

3.22. General consensus, with a few exceptions was that:

- Finance officers find the guidance helpful to use as a reference point, but welcomed the flexibility which enabled them to deviate from this in certain circumstances if the Section 151 Officer judged this to be appropriate.
- The guidance should be principles based, rather than prescriptive.
- A number of roundtable participants fed back that the suggested asset lives seemed slightly arbitrary, although others commented that they served as a useful reference point.

3.23. Legislation requires local authorities to 'have regard for' the statutory guidance. In practice, this means that if a council considers that there are reasonable grounds for deviating from the guidance, then they are required to justify this.

3.24. Some of the chosen methods of deviation from the guidance may be representative of a higher risk appetite, for example, a local authority might be prepared to accept the risk of a property not realising its anticipated value or make alternative contingency arrangements to mitigate this risk. However, it is crucial that, when considering these risks, evidence is presented to decision makers clearly and transparently, so as to enable them to make a well-informed judgement with a full awareness of the associated risk implications.

3.25. Treatment of deviations from the statutory guidance in terms of how this is presented to decision makers is varied. As part of the strategy review, some evidence of good practice was identified, in respect of setting out clearly and transparently for decision makers how the proposed policy represented a deviation from the guidance (see 'good practice examples' section for further detail). Conversely, there were other examples of policies which did not follow the guidance where this was not evidenced clearly to decisions makers. This lack of transparency presents a risk that when agreeing the MRP policy, members are not aware that the proposed policy represents a deviation from the statutory guidance and the Department should work to ensure that this is addressed.

Conclusions

3.26. The notion of affordability has become less relevant given the recent trend towards yield bearing investments, and this has resulted in the affordable borrowing limit no longer acting as a true limit.

3.27. Ongoing uncertainty regarding revenue funding for local authorities presents a barrier to properly assessing the future sustainability of an investment decision.

3.28. Guidance on MRP is considered to be useful, although the flexibility to tailor the approach to local circumstances is seen as important.

3.29. Improvements are required on the approach to reporting deviations from the statutory guidance to improve transparency for decision makers.

Next Steps

3.30. The Department will give further consideration to the role of indicators as a formal measure of proportionality and evaluate the benefits of standardising the calculation methodology.

4. Risk and Reward

4.1. Capital investment and borrowing offer significant opportunities as well as risks for local authorities.

4.2. The National Audit Office *Financial sustainability of local authorities: capital expenditure and resourcing, Jan 2016* highlights risks to future financial sustainability from continued pressure of capital costs to revenue.

4.3. Following the revisions to the framework, the review has sought to establish the level of assurance that can be derived from the approaches that councils are adopting towards balancing risk against reward. Key risks include:

- Over dependence on commercial income.
- Too much debt compared to net service expenditure.
- Growth in debt servicing costs.
- Pressure from future reductions in revenue income.

Contribution and proportionality

4.4. Although yield-bearing investments are extremely common, examples of councils investing purely with this objective in mind were relatively scarce. A common theme which emerged from both the strategy review and roundtable feedback highlighted that councils will often make yield bearing investments with the intention of pursuing one of their strategic objectives as a place-maker. For example, by contributing to housing supply in their area, town centre regeneration or to create or safeguard jobs locally. Because of this, the required disclosures around contribution and proportionality do not tell us very much on their own, with many councils disclosing that most or all of their planned investment activity made a contribution to service delivery. However the following ratios were found to be useful indicators of proportionality:

- Ratio of financing costs to net service expenditure (general fund)
- Commercial income to net service expenditure ratio

4.5. Some councils have set separate limits for commercial investments in response to the changes to the guidance. Limits may be driven by factors such as existing borrowing levels, members' risk appetite and a general view on reasonableness based on the size of the authority and the judgement of the Section 151 officer.

4.6. The review established that it is sometimes necessary for local authorities to take risks in the pursuit of policy objectives, such as contributing to housing supply, or "pump-priming" developments which will support regeneration, creating or safeguarding jobs and growing the business rates base.

4.7. It should be noted that many councils do not perceive income from commercial investment activity to be their riskiest source of revenue, and commented that they are able to forecast this with a greater degree of certainty than other sources (for example, retained business rates given the planned reforms to the system). However, where income streams are attached to corresponding liabilities, this introduced an additional element of risk. The updated investment guidance seeks to address this through introducing a requirement for strategies to state the local authority's approach to assessing risk of loss "*before entering into and whilst holding an investment*".

Use of indicators

4.8. The updated Statutory Guidance on Local Government Investments requires local authorities to develop quantitative indicators in order to allow Councillors and the public to assess total risk exposure as a result of its investment decisions. A suite of recommended indicators is provided within the guidance.

4.9. The strategy review identified a number of examples of indicators being well utilised to communicate risk, with some councils designing their own indicators specific to local circumstances.

4.10. Finance officers have fed back that some of the indicators suggested in the guidance are not particularly relevant if a council does not have a significant programme of commercial investments, and the requirement to include this information can sometimes have the effect of making the strategy unnecessarily long, resulting in the key messages being lost. Some councils elected choose not to include the recommended indicators in their strategy on this basis.

4.11. The inclusion of indicators does not appear to have had a significant overall impact on risk, decision making or transparency. Feedback from local authorities is that: there are too many indicators suggested for inclusion in the strategy; they are too complex in terms of what they are trying to present; there is no consistently prescribed methodology for calculating the indicator; and there is rarely a benchmark for the local authority to measure itself against.

4.12. The most useful indicators have been 'ratio of debt servicing costs to net revenue stream' and 'commercial income to net service expenditure ratio'. The latter was felt to be useful not only for highlighting the overall level of dependence on commercial income, but in identifying the importance of different income streams within the portfolio and ensuring that this intelligence was used to inform the ongoing investment strategy and asset management plans.

4.13. A range of different approaches have been taken to disclosure of rates of return (the guidance states that indicators should be included within the strategy disclosing 'how investments are funded and the rate of return received'). The review of strategies identified that although some local authorities had incorporated target rates of return into their strategies, many had chosen not to do this. When this subject was explored with roundtable participants, a number of local authorities explained that they had chosen to resist setting target rates of return as yield is rarely the primary driver for an investment, and this indicator would not account sufficiently for the social value of the investment.

4.14. However, it was widely acknowledged that debt servicing costs would always be assessed in the context of impact on the revenue budget, and that this acts as a key component in determining affordability.

4.15. Use of short term debt to finance the capital programme increases refinancing risk due to the potential for interest rates to rise more quickly than forecast and become unaffordable. This approach was observed in a small number of strategies selected for review.

Borrowing in advance of need

4.16. The changes to the capital finance framework sought to clarify that local 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.

4.17. CIPFA also issued a *Statement on Borrowing in Advance of Need* and *Investments in Commercial Properties* in October 2018, designed to clarify that local authority investment powers are for any purpose relevant to its functions and for the purposes of the prudent management of its financial affairs:

4.18. *"CIPFA considers that where the scale of commercial investments including property are not proportionate to the resources of the authority, that this is unlikely to be consistent with the requirements of the Prudential Code and the Treasury Management Code."*

4.19. The intention of this guidance is to discourage local authorities from borrowing with the sole intention of investing to generate a direct revenue stream. As previously identified, the majority of local authorities appear to recognise a distinction between this type of activity, and investments which generate revenue but also directly contribute to the authority's wider objectives.

4.20. However, some alternative interpretations of this guidance have been identified within the strategies subjected to review, and a small number of local authorities have fed back that they think that borrowing in advance of need guidance remains unclear and unnecessary.

Outliers

4.21. The existing framework is principles based and as a consequence the statutory guidance is open to interpretation. The discussions we have had with local authorities as part of this review have revealed that they do not consider their own investment decisions to be disproportionately risky. On the basis of self-review, this in itself is not surprising, although interestingly, it is apparent that some local authorities view the actions of their peers as imprudent.

4.22. The capital finance framework allows local authorities significant flexibilities to determine their spending plans within the boundaries of the prudential framework, which are valued by the sector. The Department is committed to a principles based framework and consequently the guidance does not require local authorities to operate within any quantitative boundaries. Instead, the principles of prudence, affordability, sustainability and proportionality act as parameters for decision making. A consequence of this design is that the Department's capacity to exercise formal control on the behaviour of outliers or those not complying with the spirit of the guidance is limited.

4.23. Attempting to place further constraints on local authority investment and borrowing activity could be restrictive and potentially risk impeding the delivery of wider policy objects such as improving housing supply and growing the business rates base. Feedback from roundtable participants was that the framework should not be redesigned due to the actions of a handful of outliers.

Other risks

4.24. The roundtable discussions identified that some local authorities were pursuing alternative delivery models to fulfil objectives that have traditionally been met through direct capital investment. Examples of this include income strip lease arrangements, or delivery of housing and regeneration projects through subsidiary companies. It is likely that such arrangements may feature differently within the local authority's financial strategies, although in substance they may represent a capital investment. It is therefore important for local authorities to ensure that equivalent governance processes are followed for these decisions due to the potentially long-term nature of the commitments.

Conclusions

4.25. Although the introduction of indicators and additional guidance around proportionality do not appear to have had a direct impact on risk, there does seem to be some acknowledgement that the revisions to the framework signalled a need for local authorities to reconsider risk, and approaches to commercial investment.

4.26. A shift towards investment in housing has been observed in some areas, although it is unclear whether or not this was linked to the revisions to the framework, or part of pre-existing plans.

4.27. Finance officers consider the existing framework to be effective and they welcome the local flexibilities that this provides. There is concern in the sector that further changes to the framework may compromise the delivery of strategic priorities in relation to regeneration and housing.

4.28. The existing framework is not designed to address some of the more extreme activity of outlier authorities who are not complying with the spirit of the guidance, should this continue into the future.

4.29. Some local authorities are engaging in commercial activity which would not necessarily be directly governed through the prudential framework.

Next Steps

4.30. The Department will continue to carefully monitor the borrowing and commercial investment trends in the sector and the impact on sector sustainability. The Department will carefully consider, with HM Treasury, what additional interventions are required if individual local authorities continue to disproportionately borrow and expose themselves to undue levels of risk. The Department will review its data needs to ensure it understands the trends and drivers of capital investment in the sector, and the associated risks to financial sustainability.

5. The Role of External Audit

5.1. One of the aims of the review was to explore how the role of audit fits into the overall framework governing local authority investment and borrowing activity.

5.2. Evidence has been gathered through reference to auditors' reports and audit plans to establish the extent to which external audit work focuses on the borrowing and investment decisions of individual local authorities.

5.3. These findings were also discussed with the National Audit Office Local Audit Code Team, who sought the views of members of the local government auditor technical network.

5.4. External auditors provide an annual opinion on the arrangements which local authorities have in place to secure value for money, alongside their opinion on the financial statements.

5.5. This work comprises a view on the authority's arrangements to:

- Make informed decisions;
- Deploy resources in a sustainable manner; and
- Work with partners and other third parties.

5.6. The guidance issued to external auditors on this work sets out the issues that auditors might consider to be significant risks such as major reorganisation, significant funding gaps in financial planning or persistently poor performance.

5.7. There is no specific requirement for work to focus on the capital finance framework, however, there is sufficient flexibility within the guidance to enable auditors to determine the significant risks for their clients on an individual basis.

5.8. The Department could go further in order to gain assurance that the investment activity of local authorities complies with the prudential code. However, if the scope of work undertaken by external audit were to increase then this would attract additional audit fees.

5.9. All local public bodies are responsible for putting in place proper arrangements to secure economy, efficiency and effectiveness from their resources. This includes taking properly informed decisions and managing key operational and financial risks so that they can deliver their objectives and safeguard public money.

5.10. Through the post implementation review, we have sought evidence of how governance around capital investment and external borrowing plans have been a focus for the work of external auditors through reference to value-for-money (VfM) findings in authorities which have taken more aggressive approach to this. It was identified that where concerns are raised regarding specific practices and reflected in the form of a qualified VFM conclusion, there tends to be a significant delay to the publication of the audit report which can limit the usefulness and impact of the findings.

5.11. The role of external auditors was discussed with roundtable participants, who provided insight into their experience of external audit focus in this area:

- Roundtable participants consistently fed back that external auditors show an interest in minimum revenue provision, particularly where the council has adopted a change in policy.
- A small number of participants commented that external audit had touched on capital investment and borrowing strategies when reviewing MTFS (Medium Term Financial Strategy) savings targets, but the approach was felt to be 'light touch'.
- Beyond this, the strategies do not appear to receive a significant amount of attention from external audit in terms of challenging assumptions. Any specific focus would usually be backward looking, i.e. after an investment had been made, rather than at strategy stage.

5.12. Auditors also provided feedback and clarification regarding how their duties are discharged, via the NAO Local Audit Code Team:

- The capital strategy and investment plans may be the subject of focus as part of the value for money conclusion, if they are identified as a significant risk.
- If there was clear evidence of risks or issues in this area, then it is likely that these would be subject to external audit review, however it would not be correct to infer the opposite: i.e. that the absence of audit focus automatically signifies that everything is fine.
- The absence of a formal process for points of clarification sometimes places auditors in the difficult position of attempting to interpret regulations in response to queries raised by their local government clients.
- A more detailed opinion which specifically focussed on capital investment would represent a separate piece of assurance work with a separate fee.

Conclusions

5.13. Based on the evidence collected from authorities during this review, external audit should not be overly relied on as a preventative control to mitigate excessively risky activity. Although the work of external auditors can provide an insight into the governance arrangements regarding particular decisions, detect weaknesses and make recommendations for improvement, the retrospective nature of external audit work means that it is unlikely to inform decision making at strategy stage and consequently it should not be view as a strategy for mitigating risk within the system.

Next Steps

5.14. The Department will consider these findings as part of its ongoing work on audit, and through its response to recommendations which arise from Sir Tony

Redmond's review of local authority financial reporting and external audit. In addition, the Department has worked with the NAO, as key stakeholders, to develop the new audit code, which came into effect from April 2020. The new code proposes changes in the way that the VFM conclusion is presented and will be supported by more detailed guidance notes to be developed over the summer.

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- West Suffolk Council

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LB Enfield	Birmingham City Council	Preston City Council
LB Lambeth	Coventry City Council	Rochdale Borough Council
LB Redbridge	Derby City Council	Manchester City Council
LB Southwark	Leicester City Council	GMCA
Spelthorne Borough Council	Leicestershire County Council	Warrington Borough Council
West Sussex County Council	Nottingham City Council	Cheshire East Council
Winchester City Council	Solihull Borough Council	Blackpool Council
Greater London Authority	Stoke-on-Trent City Council	Wigan Borough Council
Cambridge City Council	Warwickshire County Council	Lancashire County Council
Cambridgeshire County Council	Worcestershire County Council	Cheshire West & Chester Council
Peterborough City Council	Brighton & Hove City Council	Blackburn with Darwen Borough Council
Suffolk County Council	Crawley Borough Council	Durham County Council
West Suffolk Council	East Sussex County Council	Sunderland City Council
Luton Borough Council	Southampton City Council	Redcar & Cleveland Borough Council
Bath & North East Somerset Council	Portsmouth City Council	Stockton-on-Tees Borough Council
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Cheltenham Borough Council	Barnsley Borough Council	Local Government Association
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Gloucestershire County Council	Kirklees Borough Council	Treasury & Capital Management Panel
Plymouth City Council	Leeds City Council	

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