

Proposed extension to the review of subsidiaries: consultation response

November 2018

We support providers to give patients safe, high quality, compassionate care within local health systems that are financially sustainable.

Contents

1. Introduction	2
2. The main themes from consultation responses and our response	3
3. Summary of our position on the review of subsidiaries and next steps	8
Annex: Technical questions from respondents	10

1. Introduction

NHS Improvement published a consultation on proposals for extending the review of subsidiaries that ran from 17 October to 16 November 2018. The terms 'subsidiaries' or 'subsidiary companies' apply to all types of organisation owned or partly owned by a provider. 'Subsidiaries' includes companies limited by guarantee or by shares, community interest companies and limited liability partnerships.

The consultation used a combination of 'yes/no' and open-ended questions covering in detail our proposals and the associated impact for trusts. We received responses from NHS trusts and foundation trusts and affiliated subsidiaries, membership organisations, arm's length bodies and professional services firms.

The main themes that emerged from consultation responses were:

- regulatory and administrative burden on providers
- additional criteria for reporting subsidiaries
- definition of material changes for subsidiaries
- use of a panel to review initial subsidiary proposals.

Section 2 explores these themes and how we will mitigate concerns raised.

Section 3 summarises how we will take forward the proposed changes.

The Annex answers some specific technical questions raised by respondents.

2. The main themes from consultation responses and our response

2.1. Proportionality of oversight and increased regulatory burden

Responses to the proposed change to the threshold for reporting subsidiaries varied and highlighted the sensitivities and variety of opinion on using such vehicles in the NHS. Several respondents supported the transparency resulting from making all subsidiaries reportable. However, others felt that extending the requirements to subsidiaries created a potential conflict with their independence from parent trusts, particularly for future material changes.

Several respondents expressed concern about the risk of a lengthy, complex review process with undefined criteria. Some also expressed concern at a lack of parity compared to the regulatory approach for contractual outsourcing arrangements, which are not covered by the updated approach for trust transactions to form or change a subsidiary.

Our response

We recognise the potential increased burden of oversight resulting from these changes. However, we have committed to articulating:

- the circumstances where a full review will be required
- what is and is not likely to be acceptable to allow a case to go ahead as soon as practicable.

As outlined in our consultation document, we recognise that the current risk factors in the [transactions guidance](#) do not consider risks specific to subsidiaries. For example, the guidance is ambiguous about the impact of transferring assets from trusts to subsidiaries; it is therefore not always clear to trusts whether a transaction is reportable on this basis, and this guidance clarifies our position.

We recognise the argument about subsidiaries' independence, but we believe they are not so independent from trusts as to fall outside the review requirements.

Similarly, while we understand the argument about the different regulatory approaches for subsidiary transactions and outsourcing contracts, we believe there are specific risks associated with subsidiary transactions that do not apply to outsourcing contracts: for example, in relation to any trust staff transferring into the subsidiary, and potentially more significant reputational, quality, operational and financial risks for the trust as a result of its ongoing ownership interest in the subsidiary.

As set out in Section 1.3 of the addendum to the transactions guidance, we commit to reviewing the approach after one year to ensure it is appropriate and proportionate. We will continue to refine the approach as we develop a better understanding of the risks specific to subsidiary transactions.

We are conscious of the need to manage regulatory burden and have designed the updated process with this objective in mind. In the addendum to the transactions guidance we have indicated timescales of approximately three weeks for the review process applicable to all transactions, and timescales of four to six weeks for the detailed review of transactions classified as significant. As set out in Section 4 of the addendum to the transactions guidance, the information submission requirements for subsidiary transactions should be the same information as required by the trust board, so should not impose any extra burden on the sector.

The addendum also clarifies the review criteria. Appendix 1 and Appendix 2 of the addendum set out the risks that we expect trust boards to consider, and which we will consider as part of the review process.

2.2. Additional criteria for the reporting of subsidiaries

As part of the consultation, we asked for suggestions for criteria that could be used to determine whether a review of a subsidiary is necessary. Several respondents felt that the thresholds in the transactions guidance were adequate (defined as planned variations to assets, income or capital that change by more than 5% (for non-healthcare) or 10% (for healthcare)). Some respondents suggested that a *de minimis* value could be created (£10 million was one suggestion) but several

respondents also said there should be both qualitative and quantitative factors when determining the threshold for review.

Several respondents identified specific criteria that could be used, which were above and beyond the current guidance, including the number of staff being transferred, or whether a subsidiary was novel and contentious.

Our response

Responses to the consultation were very helpful and outlined some of the risks that existing subsidiaries have encountered in their operations. We have noted some of these criteria and, through the updated review process, expect to be able to refine the criteria and publish a detailed list to provide greater clarity to trusts developing their plans. In line with our commitment to review the updated process, we would expect to publish these criteria within a year of implementation.

In advance of publishing specific criteria, we have reflected several of the risks identified in our revised board certification, which is specific to subsidiaries and will be required to be completed by all trusts. This board certification is included as Appendix 1 in the [addendum to the transactions guidance](#). Appendix 2 of the addendum sets out the indicative scope of the review for subsidiary transactions classified as significant.

2.3. Material changes to current and future subsidiaries

As with previous questions in the consultation, responses to this were mixed. Some respondents were concerned that the proposed approach would compromise subsidiaries' ability to respond quickly to maximise market opportunities. Some were in favour of a risk-based approach to determining materiality and provided helpful suggestions on potential considerations for classifying changes as material. Some respondents expressed concern that proposals to review material changes to existing subsidiaries conflicts with the independence of the directors of the subsidiary. This is discussed in the Annex, Question 3.

Our response

In developing a review process specifically for subsidiaries, we recognise that we need a clear timetable for review. We have clarified this in the addendum for subsidiaries with an expectation that any review required for transactions classified

as significant should take around six weeks to complete and therefore should not impact on the ability of organisations to be agile in developing their plans.

The addendum to the transactions guidance clarifies that determining whether something is a 'material change' will be done on a case-by-case basis. We have provided examples of changes that may be material, which take account of respondents' suggestions. These include asset sales or transfers, and changes to the subsidiary's risk profile, which may include changes to staff terms and conditions of employment, the ownership share of the subsidiary, or the scale or scope of the subsidiary's activities. We ask that trusts engage with regional teams as early as possible, so we can plan our resource and meet expectations on timings of review.

2.4. Use of a panel for initial review of subsidiary business cases

Responses to this question were again mixed, with concerns about the risk of inconsistency of review, as well as the panels' capability and capacity to undertake the reviews on a timely basis. Several respondents did welcome the panel review, stating that panels could more accurately consider the nuances of individual business cases, and not just a 'one size fits all' approach.

Our response

We believe the panel is the best mechanism to review business cases initially, given the significant variation in the nature, size and strategies of subsidiary plans in development. The panel allows for consistent review of normal transaction risks around governance, finance, quality, etc but brings in subject matter experts to reflect the specifics of the business case. We recognise that some respondents were concerned about the panel's capacity and capability, but we believe there is sufficient and appropriate resource to deal with reviews on a timely basis. Further to this, as outlined in the addendum, we expect a six-week review period when a transaction is deemed to be significant and a detailed review is required (subject to receiving a detailed and approved business case from the trust).

We believe that using the panel will allow for precedents to be developed that can be codified and included in a revised update and review of the process as soon as is practicable. As a starting point we have included as Appendix 2 to the addendum

an indicative scope for the review of subsidiary transactions classified as significant. This should ensure a consistent approach to review of risks common to all subsidiary transactions, while allowing for the necessary flexibility to consider the inherent risks of each proposal.

2.5. Ongoing review of our approach to the review of subsidiaries

Respondents to the consultation expressed concern that the process was an unnecessary departure from the current process and subsidiaries did not propose the level of risk that would warrant a separate approach.

Our response

As outlined in previous responses, we are committing to an ongoing review of the process that we have developed to ensure a proportionate review of companies. We believe that the risks associated with subsidiaries warrant an additional process, but we recognise that this needs to be clearer for trusts to develop their plans.

The addendum to the transactions guidance contains an initial view of the key risks for trust boards to consider. We will continue to refine this and evolve our approach as we review more subsidiary transaction proposals.

3. Summary of our position on the review of subsidiaries and next steps

Following consultation and detailed consideration of the main themes coming out of the consultation, our approach to the review of subsidiaries is described below. Alongside this response to the consultation we have produced an [addendum to the transactions guidance](#).

We also plan to publish soon supplementary guidance for trusts developing plans for subsidiaries, including information to support them.

3.1. What level of review will subsidiary companies be subject to?

We will require all proposals to create subsidiary companies to be reported to us.

On receiving an approved business case from a trust, we will consider the proposals and the relative risks involved in the business case and determine the level of regulatory approval required and whether a transaction is 'material' or 'significant'.

At a minimum, we will consider a subsidiary transaction 'material' after reviewing the business case to understand the specific risks. We will require the completion of a board self-certification on the risks involved in developing the subsidiary. Should the business case identify several areas of risk, or that the risks identified are considered sufficiently high, the transaction will be considered 'significant' and subject to a more detailed review depending on the relative risks involved in the proposals. The review process for a significant transaction is expected to take six weeks.

3.2. When will the risk factor criteria for reviews be published?

We are committed to reviewing the process over the next year to further develop and outline the risk factors that we believe should trigger the review of a business case for a subsidiary.

With that in mind, we are keen to discuss the operation of longstanding subsidiaries to understand more about the risks and the learning from their operation. By doing this, we hope to be able to publish more specific risk factors to provide clearer guidance to trusts on what will require a review in the future. We will also be able to provide clearer parameters around the level of review required, clarify expectations for a subsidiary transaction to be rated green or amber and provide guidelines on when changes to existing subsidiaries will be classified as 'material'.

3.3. How will we identify potential 'expert' panel advisors from current trusts or subsidiaries?

During the consultation, several trusts and subsidiaries contacted us to offer further meetings and discussions on how their subsidiaries operated and to offer views and information on the risks associated with their own proposals. We found this information very helpful and we welcome further engagement with other providers.

If any other providers would like to engage with us, and potentially be involved in being an expert panel advisor, please contact us at nhsi.subsidiaries@nhs.net.

Annex: Technical questions from respondents

1. Income generation

Consultation responses

Some respondents requested clarity on what is meant by ‘for income generation purposes only’ in relation to NHS trusts which, under paragraph 20(1) and (2) of Schedule 4 of the NHS Act 2006, may form or participate in ownership of a subsidiary company for income-generation purposes only.

Specifically, respondents queried whether a subsidiary can only be outward facing or whether it could deliver services back to the parent trust and still be regarded as being for income-generation purposes.

Clarification was requested on whether ‘income generation’ excludes income from the wider public sector.

NHS Improvement response

Both the consultation document and the addendum to the transactions guidance reiterate the current legal position: that is, that NHS trusts can form or participate in ownership of a subsidiary for income-generation purposes only. As set out in Section 3.2 of the addendum to the transactions guidance, we are discussing with the Department of Health and Social Care (DHSC) a revised process for obtaining the Secretary of State’s support for NHS trust subsidiary transaction proposals.

As part of this, in early 2019 we will provide further information, including any specific tests and thresholds used to determine whether a subsidiary transaction proposal is for income-generation purposes as defined by the guidance from DHSC.

2. Clarification requested on whether the definition of ‘subsidiary’ includes joint ventures

NHS Improvement response

The addendum to the transactions guidance says:

“The term ‘subsidiary’ means a separate, distinct legal entity for the purposes of taxation, regulation and liability owned or partly owned by a provider. ‘Subsidiary’ includes companies limited by shares or companies limited by guarantee, limited liability partnerships and community interest companies.

For clarity, ‘subsidiary’ includes joint ventures falling within the definition above”.

In practice this means that a corporate joint venture falling within this definition will be regarded as a subsidiary. However, a contractual joint venture that is not a separate, distinct legal entity would not be captured by this definition.

3. Independence of subsidiary directors and conflicts of interest

Consultation responses

Concerns were raised that the proposed regulatory approach is not aligned with the principle of trust board autonomy and may result in a loss of corporate independence of the subsidiary. It was noted that the subsidiary’s directors are duty bound to consider what will lead to the organisation’s success. Concerns were expressed that introducing a panel review, which may have other drivers, could impact on directors’ duties and result in conflict.

NHS Improvement response

The focus of the review process, for proposals to create new subsidiaries or make material changes to existing subsidiaries, is on whether these would result in significant unmitigated risks for the parent trust that we regulate. We review proposals through the lens of the trust that we regulate. We do not believe that this approach compromises the independence of the subsidiary’s directors, who should continue to act in the best interests of the subsidiary’s owners (which would include the parent trust).

As set out in the addendum to the transactions guidance, when considering the extent of any NHS Improvement review required for proposed changes, we will take into account existing trust and subsidiary governance processes (which will have been considered as part of the review when the subsidiary was created) and the extent to which we can be assured that risks to the parent trust have been considered and mitigated via these governance processes.

Where the subsidiary is an NHS-controlled provider, it would be regulated by NHS Improvement. In these circumstances, NHS Improvement has direct regulatory responsibility in relation to material changes to the subsidiary, not just through its NHS parent.

4. Expert panel members and potential conflicts of interest

Consultation responses

Concerns were expressed by some respondents about potential conflicts of interest relating to subject matter experts forming part of the review panel, as many potential experts will be employed by existing subsidiaries, which are potentially competitors for the proposed subsidiary. On a related point, concerns were expressed about the review of commercially sensitive business cases by potential competitors.

NHS Improvement response

We recognise the argument about the commercial-in-confidence nature of business case submissions and potential conflicts of interest.

As set out in the addendum to the transactions guidance, subject matter experts may be used to advise the panel, rather than sit on the panel itself. The panel can therefore benefit from the subject matter expert's insights without conflict of interest risks relating to the panel decision. We will draw from experts who do not have an interest in the proposal under consideration: for example, the expert could be a person from a different part of the country to that covered by the proposal. We will ensure the subject experts are under a duty of confidence. Trusts will have the 'right to refuse' an expert on reasonable grounds.

For clarity, the panel makes no firm decision as such; its decision relates to the transaction classification only, which determines the level of review that is to follow.

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