Date: 2nd February 2010

Appendix 2

Our Ref: AMH/AMH

Your Ref:

The Rt. Hon John Healey MP
Minister for Local Government
Department for Communities and Local Government
Eland House
Bressenden Place
London SW1E 5DU

DRAFT

Cllr Mrs Diana Collins (01992) 564051
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Dear Mr Healey

Council House-Building – Financial Obstacle

My Council has retained its housing stock (currently comprising around 6,500 properties) following a detailed options appraisal that established: that our tenants wished to retain the Council as their landlord (mainly due to our continual high levels of tenant satisfaction); that we can meet the Decent Homes Standard by the end of 2010; and that our HRA is forecast to remain in surplus for the foreseeable future.

We have been considering in some detail the possibility and implications of re-commencing a programme of Council house-building, on Council-owned land, following your Government's relaxation of the financial regulations in relation to the retention of rental income and capital receipts from future sales, in respect of newly-built Council properties.

As a result, at the meeting of my Council's Cabinet last night, it was agreed in principle that, subject to such a programme not having any detrimental financial effect on the Council's General Fund, the Council should recommence a programme of new social house-building. However, our detailed consideration has identified a major financial obstacle for us, which results in my Council being unable – at the present time – to move forward on this initiative.

My Cabinet therefore agreed that I should explain this financial difficulty to both yourself and the Local Government Association (LGA) to ask you if, in view of your Government's previous commitment to remove any obstacles that stop councils from building new Council homes, you could assist in overcoming this problem – which relates to the Council's Capital Financing Requirement.

I have explained the problem in detail below but, in simple terms, I am advised by our officers that - due to our Capital Financing Requirement - if my Council borrowed money through a loan (under the prudential borrowing arrangements) in order to supplement any social housing grant from the Homes and Communities Agency (HCA) to meet the capital costs of building new homes, although those new homes would be held in the Housing Revenue Account (HRA) - with the rental income being received by the HRA - the cost of the loan would have to be borne by the General Fund.

If, for example, the Council borrowed £2m to fund, say 40 properties, the cost to our General Fund would be around £106,000 per annum over the period of the loan (assuming there was no change in interest rates). Similarly, if £4m was borrowed for the construction of, say 40 properties, it would cost our General Fund around £212,000 per annum. However, all the rental income from these properties would be received by our HRA which, conversely (and unlike housing associations) would not have to service the loan. Therefore, our HRA would financially benefit to a significant extent, and our General Fund would be detrimentally affected to a significant extent.

I am sure you will appreciate that, in the current economic environment and the anticipated reduction in public sector spending, such a cost to our General Fund would not be sustainable. It is for this reason that we have had to take the reluctant decision that we cannot re-commence a programme of Council house-building under the current local government accounting requirements.

Although the extent of this problem will vary between authorities – with some not being affected at all – I would be surprised if a number of other councils did not have a similar concern.

Therefore, in the light of this problem, I would be grateful if you could consider amending the accounting requirements, as appropriate, to remove this obstacle. In simple terms, any change would need to result in the HRA being required to meet the cost of borrowing, from the rental income it receives.

The more detailed explanation of this problem is quite complex. I have therefore attempted to simplify the position for you as follows:

You will appreciate that only the Council, as a legal entity, can borrow money, and the HRA cannot in itself 'borrow' money. Therefore, if the Council makes such a decision, the cost of borrowing would initially fall on the General Fund and would then be "recharged" to the HRA on a prescribed basis.

The prescribed basis for recharging the cost of borrowing refers to what is called the Capital Financing Requirement (CFR). The CFR can be defined as a measure of the Council's need to borrow in order to finance capital expenditure. The CFR is split between a General Fund (GF) CFR and a Housing Revenue Account (HRA) CFR.

For my Council, our overall CFR is currently negative £784,000. This means that, under the accounting regulations, the Council is considered to have no need to borrow any money in order to fund our existing Capital Programme. However, my Council can still choose to borrow, provided that such a loan is 'affordable' in the long term – i.e. meets the requirements of prudential borrowing.

For my Council, the split of the overall CFR is that the HRA CFR is negative £22,803,000, and the GF CFR is positive £22,019,000.

Therefore, if we borrow £2m to fund the construction of new homes, the effect would be to increase the overall CFR by £2m, to £1,216,000 (i.e. £2m minus £0.784 m). This would be made up of the HRA CFR being negative £20,803,000 and the GF CFR being positive £22,019,000. Therefore, the HRA would still have "no need" to borrow; all that would have happened is that the GF would have replaced a "loan" from the HRA with a loan from an external source.

The cost of the loan would therefore be a charge, initially, to the GF - but there would be an assumption that this would then be recharged to the HRA, based on the HRA CFR. However, the HRA CFR would still be negative. Therefore, there would actually be no basis to recharge the HRA, since – according to the accounting rules – the HRA would have no underlying need to borrow. Consequently, the total cost of the loan (i.e. the interest and principal) would fall on the GF.

This would mean that both the interest (currently estimated at around 4.3%) and the Minimum Revenue Provision (MRP - a sum that would have to be set aside from revenue budgets to pay off the loan principal), estimated at 2%, would fall on the GF.

Interest would have to be charged to the GF at the Consolidated Rate of Interest (CRI), which you may be aware is the average rate of interest payable on the money borrowed. Since there would only be one loan of (say) £2m - this CRI would also be (currently) around 4.3%. If other loans were subsequently taken out, the CRI would move up or down, depending on the rates and terms of those loans. Crucially, the HRA would only contribute to the borrowing costs, once the HRA CFR becomes positive. i.e. in our case, if over £22.803m is borrowed.

On a slightly separate issue, you will be aware that the Council receives investment interest from our “unused” capital receipts and other “unused cash”, although the rate is currently very low (under 1%); the allocation of income between the GF and HRA has to be based on the CFR. This applies regardless of whether the Council has debt or not.

Therefore, if we borrowed say £2m to finance new house-building, the HRA would lose some of the interest income from the Council’s investments and the GF would gain investment income. This is because the allocation of investment income would be based on an HRA CFR of £20.803m, multiplied by the CRI - rather than an HRA CFR of £22.803m.

However, as I have explained earlier, any proposal to build Council houses at present would, overall, be detrimental to the GF. If the Council borrowed £2m to fund, say 40 properties, it would cost the GF an amount estimated at £106,000 per annum (£2m X 6.3% = £126,000) – (£2m X 1% = £20,000 lost investment interest). If £4m was borrowed for the construction of, say, 40 properties, it would cost the GF around £212,000 per annum.

If at some point in the future, investment interest rates exceed the CRI plus the MRP, then the GF would gain. You will appreciate, though, that the likelihood of this is somewhat slim and, again, would only be temporary until interest rates rise again.

No doubt you will seek the advice of your finance staff on the detailed explanation above. However, if they concur with the advice provided to me by my officers, I would be grateful if you could take the necessary steps to amend the accounting regulations to enable my Council, and no doubt other councils in a similar position, to build Council homes once again - which is not only an aspiration of my Council, but also a stated intention of your Government.

In accordance with the decision of my Cabinet, I have sent a copy of this letter to the Chief Executive of the Local Government Association, with a request that he assists with the removal of this obstacle in any way that he can.

I look forward to receiving your reply.

Yours sincerely,

Cllr Mrs Diana Collins
Leader of the Council