Report to the Cabinet

Report reference: C-101-2009/10

Date of meeting: 19 April 2010

Epping Forest District Council

Portfolio: **Housing.**

Subject: **Formation of Local Housing Company – Legal and Financial Appraisals**

Responsible Officer: **Alan Hall (01992 564004).**

Democratic Services: **Gary Woodhall (01992 564470).**

Recommendations/Decisions Required:

(1) That, having considered the financial implications of the initial proposal to form a Local Housing Company (LHC) to which the Authority could provide mortgages to enable the company to purchase properties on the open market and to let them with assured tenancies at market rents to Council Housing Register nominees, the proposal is not pursued any further; and

(2) That the Local Government Association be advised of the outcome of the Council's Feasibility Study.

Executive Summary

The Cabinet has previously agreed to investigate the feasibility of forming a Local Housing Company (LHC) to which the Council could provide mortgages, in order to enable the LHC to purchase properties from the open market and to then let them with assured shorthold tenancies at market rents to Council nominees.

This report provides the Cabinet with details of the legal advice received from a specialist firm of solicitors on the proposal, which the Cabinet agreed to appoint, and provides information on the outcome of the financial appraisals undertaken. It concludes that the proposal should not be pursued further.

Reasons for Proposed Decision:

The financial appraisals undertaken by the Council's Finance and ICT Directorate show that, although the proposal is likely to be financially beneficial to the Council, it is unlikely that the Local Housing Company (LHC) itself would be viable, due to the anticipated shortfall in likely rental income to meet the LHC's costs.

Other Options for Action:

To form a Local Housing Company – but this is not recommended, since the financial appraisals show that the LHC would not be viable.

Report:

Introduction

1. At its meeting in September 2009, the Cabinet considered a proposal from the Leader, Deputy Leader and Housing Portfolio Holder to investigate the formation of a Local Housing Company (LHC) to which the Council could provide mortgages, to enable the LHC to purchase properties from the open market and to then let them with assured shorthold tenancies at market rents to Council nominees. It was felt that, in the current economic climate of low interest rates, it may be possible for the interest payments received from such mortgages to the Local Housing Company to be greater than the interest received from the Council's normal investments.

2. The other potential benefit could be a social one, since it was felt that the LHC may be able to let the properties to Council nominees from the Housing Register, which would include applicants in receipt of the local housing allowance (housing benefit), who would otherwise experience difficulty in accessing the private rented sector.

3. It was also noted by the Cabinet that the Council is unable to provide assured shorthold tenancies at market rents to housing applicants itself, hence the need to form a Local Housing Company. However, it was agreed that, since such an arrangement would be fairly unique, specialist legal advice should be obtained on a range of issues, to assist the Cabinet and the full Council to determine whether or not to proceed. It was also acknowledged that it would be necessary to undertake more detailed financial appraisals of the potential costs and income, to establish whether or not the initiative would be financially viable.

4. The Cabinet therefore agreed that a legal firm that specialises in this area, Trowers and Hamlin, should be appointed to investigate and report on the relevant issues, for a fee of £1,500 plus disbursements. It was agreed that a further report be considered by the Cabinet in due course, setting out the legal, financial and other issues and whether or not the initiative should be considered further.

Legal Advice from Trowers and Hamlin

5. Draft legal advice was received from Trowers and Hamlin in December 2009. Following discussions between the Director of Housing, Asst. Director of Corporate Support Services (Legal) and the Asst. Director of Finance and ICT (Accountancy), a list of queries in relation to the advice were raised, on which Trowers & Hamlin were asked to expand and clarify. The final version of the legal advice received from Trowers and Hamlin is attached as Appendix 1.

6. The following summarises the key points of the legal advice:

(a) The Council is legally able to form a company (referred to in this instance as a "Local Housing Company (LHC)"), which is relatively easy. The most appropriate form would be a company limited by shares, with the Council being the sole shareholder.

(b) The consent of the Department of Communities and Local Government (CLG) would be required.

(c) The directors of the LHC, who would all be Members of the Council, would have a number of important legal duties, responsibilities and liabilities, although they would not have personal responsibility for debts of the LHC, provided that they comply with the law. Directors' Liability Insurance can be obtained. The directors would also have to act in the best interests of the LHC.

(d) The directors of the LHC can be appointed and removed by the Council

(e) Directors of LHCs are not normally remunerated or paid for their work. Indeed, if Council members who are directors of the LHC are paid, it would probably disqualify them for continuing to be a Member of the Council, because they would effectively be employed, indirectly, by the Council.

(f) There could be a conflict of interests for members.

(g) The LHC would need to have Articles of Association, setting out how the LHC will operate. Annual returns would have to be filed with Companies House and the LHC's accounts would have to be grouped with the Council's own accounts.

(h) The LHC would not be able to recover VAT for repairs that it undertakes. It would also be liable for Corporation Tax on any surpluses it makes each year and capital gains tax on any surpluses from any future sale of properties.

(i) The mortgages provided to the LHC would need to be carefully drafted, to ensure that they do not fall foul of any state aid rules, and would be secured on the properties purchased by the LHC.

(j) There would be various agreements between the LHC and the Council, including the Loan Agreement and Charges, a Nomination Agreement and a Services Agreement.

(k) The Services Agreement would set out the services that the Council would provide to the LHC, for an agreed price.

(l) The Council, as sole shareholder, would be entitled to any surpluses made by the LHC;

(m) The key risks identified by Trowers and Hamlin are:

(i) The purchased properties could reduce in value;

(ii) The purchased properties may not be able to be let, incurring void costs, or the tenants could accrue rent arrears;

(iii) The Local Housing Allowance (similar to housing benefit) is payable to tenants direct, which could lead to increased rent arrears;

(iv) There could be expensive structural problems with the purchased properties;

(v) The Council may not have adequate security for its mortgages, if the properties' values reduce;

(vi) If the LHC becomes insolvent, the Council could be one of a number of creditors and may not be able to recover its loans – although the Council should be the first in the line of creditors; and

(vii) The Council could be considered as a "shadow director" and an aggrieved creditor could try to assert that that LHC's directors had been doing "what the Council had told them to do" – however, there should be no liability for the Council, provided that the directors never trade whilst knowingly insolvent.

(n) Although Trowers and Hamlin are aware of two London Boroughs that are also considering the establishment of LHCs, to receive and let void Council properties, they appear to differ from the Council's proposal in two ways. Firstly, it appears that neither intend to let properties at market rents (one certainly intends to let the properties at "intermediate" rents – around 80% of market rents). Secondly, neither council intends its LHC to purchase properties off the open market. For these two reasons alone, this Council's proposal appears to be unique in local government.

Financial Appraisal of Proposal

7. Following discussions between housing and finance officers regarding assumed income, costs and other factors, the Council's Finance and ICT Directorate has produced three analyses, which are attached as Appendices. These are:

Appendix 2 Indicative 10-Year Business Plan for the LHC, based on the LHC charging rents *at maximum housing benefit limits*, with a sensitivity analysis of the effect on the LHC's profits using different assumptions;

Appendix 3 Indicative 10-Year Business Plan for the LHC, based on the LHC charging rents *at a yield of 6% of the property value,* again with a sensitivity analysis of the effect on profits of different assumptions;

Appendix 4 The assumptions used (for each of the 10 individual years) for both Indicative Business Plans; and

Appendix 5 The ***additional*** annual income that would be received by the Council *(based on the 6% yield Indicative Business Plan)* compared to the income that would be received from the Council's normal investments.

Findings of the Financial Appraisals

(a) Rents at Housing Benefit Levels – Appendix 2

8. The Assistant Director (Benefits) has advised on the maximum rent that could be charged for the properties, in order for the rents to be fully covered by housing benefit. A rent increase of 1.5% per annum has been assumed.

9. Based on this information, and officers' most realistic assumptions, the Indicative Business Plan for the LHC shows that the LHC would only be viable for Years 1 and 2 (because of a relatively low interest rate that would be charged by EFDC for the loan in the current economic climate). However, after this, the Indicative Business Plan shows that the LHC would generate an annual loss of between £56,000 and £62,000 per annum. This is due to the assumed cost of the loan being based on Base Rate + 1%, and that EFDC's financial advisers, Butlers, forecast the Base Rate for 2012/13 (Year 3) onwards to be 4.5%.

10. Moreover, the Sensitivity Analysis shows that none of the alternative assumptions would result in a surplus for the LHC over the long term.

11. One of the proposed benefits of the initiative, is that the LHC's properties could be let to housing applicants in receipt of housing benefit. However, this appraisal shows that this would not be possible, since the rents charged to meet housing benefit limits would be too low for the LHC to sustain.

(b) Rents based on an annual yield of 6% of Property Value – Appendix 3

12. This is a similar analysis to (a) above, but with higher assumed rents based on a realistic yield.

13. This shows that the LHC would be viable in Years 1 and 2, but would still generate a loss between Years 3 and 9, before making a small surplus again in Year 10. This is due to the cost of the loan remaining stable from Year 3 onwards and assumes that rents would increase by 1.5% per annum.

14. The Sensitivity Analysis also shows an ongoing loss for all of the alternate assumptions, except for two assumptions:

- If the loan cost is 1% (or more) lower in the long term than has been assumed. If the loan interest charged by the Council was at Base Rate (instead of Base Rate + 1%), the LHC would generate a surplus of between £17,500 and £76,300 per annum. However, the income to the Council (from the loan interest) would be reduced accordingly.

- If the yield from the rental income is 7% (or more) of the property value. This would result in the company making a surplus of between £16,600 and £75,000 per annum. This would not result in any reduced income to the Council.

(c) Income to the Council – Appendix 5

15. Appendix 5 shows the anticipated ***additional*** income that the Council would receive (which is the main driver for the initiative), based on rents charged to produce a yield of 6%, compared to the anticipated income the Council would receive from its usual investments. The anticipated income would be received from the following sources:

- The interest from the loan to the LHC;
- The income received from the Services Agreement, for services provided by the Council to the LHC (assuming no additional staffing resources are required by the Council); and
- The profits from the LHC (which would be required to be passed to the Council under an agreement with the LHC)

16. In addition, the Council would benefit from any net capital receipts that may arise when the LHC's properties are sold (after taking in to account any capital gains tax and assuming that property values increase – if they reduce, it would result in a loss to the LHC).

17. It should be noted that this additional income would have to be shared by the HRA and General Fund on the basis of 60:40.

18. The "Investment Lost" (i.e. the interest the Council would receive from its usual investments) assumes an interest rate based on a 3 month fixed rate deal.

This loss would also be split between the HRA and the General Fund, approximately 60:40.

19. This analysis shows that, as expected, there would be an annual overall surplus to the Council (i.e. additional income, above what the Council would receive from normal investments).

20. Moreover, the Sensitivity Analysis shows that, except for the following two assumptions, additional income would be received for any of the alternate assumptions. The exceptions are:

- If interest received from EFDC's usual investment sources is 1% higher - which would result in a loss in Years 3 to 8; or
- If rental income received by the LHCs is 1% lower – which would also result in a loss in Years 3 to 8.

Conclusion

21. The main drivers for the Council to consider establishing an LHC have been:

- Increased income for the Council, compared to its usual investment sources; and

- Housing applicants, who normally have great difficulty in accessing the private rented sector, being able to rent privately – even if they are in receipt of housing benefit.

22. As the Financial Appraisals demonstrate, the model would certainly not work if the LHC was constrained by charging rents at no more than the maximum housing benefit levels. Therefore, the only housing applicants who would benefit would be those on reasonable incomes who are prepared and able to pay full market rent, not those in receipt of housing benefit. Arguably, such applicants would be able to access the private rented sector, without the assistance of the LHC.

23. Appendix 3 demonstrates that, even if a yield of 6% was achieved (which is considered reasonable in the long term), based on officers' most realistic assumptions, the LHC itself would be unviable. Only if the interest rate on the Council's loan was 1% lower than assumed, or a yield of 7% could be achieved, would the LHC be a viable company.

24. Notwithstanding the apparent unviability of the LHC itself, the appraisals show that, as originally identified, it is likely that the Council itself would receive additional income through the initiative. However, this could only be achieved on the basis of the LHC itself being viable.

25. In view of the likelihood that the LHC would not be a viable company in the long term (i.e. 10 years), unless a number of improved variables came into play, and bearing in mind the significant amount of public money that would be placed at risk, it is felt that the initiative should not be pursued further.

26. Since the Local Government Association (LGA) has shown interest in the proposal, it is suggested that the outcome of the Feasibility Study is shared with the LGA.

Resource Implications:

None – If the recommendation is agreed.

Legal and Governance Implications:

None. If the formation of a Local Housing Company is pursued, these are set out in the advice from Trowers and Hamlin, attached at Appendix 1.

Safer, Cleaner and Greener Implications:

There is none.

Consultation Undertaken:

The Local Government Association (LGA) has been consulted on the principles and has expressed an interest in being kept informed.

Background Papers:

Brief to Trowers and Hamlin.

Impact Assessments:

<u>Risk Management</u>
The risks identified by Trowers and Hamlin are set out in Appendix 1, and are summarised in the report above.

Officers are of the view that, the significant financial risks that the feasibility study has identified, preclude the formation of a Local Housing Company.

<u>Equality and Diversity:</u>

Did the initial assessment of the proposals contained in this report for relevance to the Council's general equality duties, reveal any potentially adverse equality implications?	No
Where equality implications were identified through the initial assessment process, has a formal Equality Impact Assessment been undertaken?	N/A

What equality implications were identified through the Equality Impact Assessment process?
N/A.

How have the equality implications identified through the Equality Impact Assessment been addressed in this report in order to avoid discrimination against any particular group?
N/A.