Report to the Cabinet

Report Reference: C-011-2011/12
Date of meeting: 18 July 2011

Epping Forest District Council

Portfolio: **Finance & Economic Development**
Housing

Subject: **Self Financing for the Housing Revenue Account**

Responsible Officer:	**Bob Palmer**	**(01992 564279).**
	Alan Hall	**(01992 564004).**
Democratic Services:	**Gary Woodhall**	**(01992 564470).**

Recommendations/Decisions Required:

(1) That the Cabinet's previous decision, in principle, to commence a new affordable house-building programme once the Housing Revenue Account (HRA) moves to a self-financing basis be confirmed, subject to financial appraisals confirming the viability of such a programme;

(2) That, subject to the decision at 1. above, the potential amount of resource to be allocated to house building, and whether this should be financed from borrowing or through surpluses generated on the HRA, be agreed in principle;

(3) That the Housing Scrutiny Panel be asked to consider the detailed issues relating to the feasibility of undertaking, and the best way of implementing, such a Programme and to make recommendations to the Cabinet accordingly;

(4) To obtain a credit rating for the Council as part of the borrowing process;

(5) To recommend to Council a supplementary HRA revenue estimate of £50,000 to cover additional consultancy and treasury management advice and the initial cost of obtaining a credit rating; and

(6) To waive the requirements of Contract Standing Orders C3 and C4 for the items in recommendation 5 above.

Executive Summary:

Before determining the number, size and maturity of the loans the Council will take on as part of the change to self financing for the HRA, the Cabinet must decide whether or not to re-confirm its previous decision, in principle, to commence any new affordable house-building programme on Council-owned HRA land.

If the Council decides, in principle, that it wishes to build new affordable homes, further decisions are necessary in terms of the potential size of the programme and how the expenditure will be financed. At this stage it is not possible to set out any proposed developments, and the viability of such a programme and how it could be implemented will require further detailed consideration by Officers and Members. Furthermore, each potential scheme would need to be assessed on its own financial merits, with a detailed development appraisal approved, before proceeding. However, in principle decisions at this stage are

needed to allow more detailed financial models to be constructed with a clearer idea of how much will be borrowed and the resources that will be available to repay the borrowing.
Local authority borrowing has traditionally been financed through the Public Works Loans Board (PWLB), as it has been the cheapest source of funds. Going forward it may be possible to obtain funding more cheaply from issuing bonds, either by means of a public bond issue or through a private placement. For any bond to be attractive to the financial markets, and in order to obtain the best possible interest rates, the Council would need to have a credit rating.

Borrowing in the region of £200million will be the largest and most complex financial transaction the Council has had to undertake. In making recommendations about the borrowing it is essential that the work of officers is supported by specialist consultancy and treasury management advice. The 2011/12 HRA estimates do not include funds for either obtaining a credit rating or external advice and so a supplementary estimate is necessary.

Reasons for Proposed Decisions:

A decision is needed on the Council's ambitions for the commencement of any house-building programme, as this will inform other subsequent decisions on the size and composition of the loan portfolio.

To give the Council the greatest range of options for borrowing and to obtain the borrowing at the cheapest rate it is necessary to obtain a credit rating. Having a credit rating will improve investor confidence and make any bonds issued by the Council more attractive.

It would not be responsible of officers to make recommendations of such financial significance without obtaining appropriate external advice.

Other Options for Action:

(a) The Council could decide, in principle, not to undertake a new house-building programme.

(b) A maximum programme cost could be agreed, for example £10 million.

(c) The programme could be either financed from additional borrowing at the start of self financing or through surpluses generated by the HRA.

(d) The Council could decide not to obtain a credit rating and to minimise the use of external advisers, although these options would be unlikely to secure the best possible outcomes for the Council.

Report:

1. On 6 June 2011, Cabinet decided to recommend to Council changes to the Treasury Management Strategy to allow the Council to take on £200million of borrowing. This was a necessary first step along the path to self financing for the HRA. Having put the ability to borrow in place, a key decision is now needed on whether the Council wants to build new affordable housing, following the Cabinet's previous decision in principle to follow such a course. If the Council re-confirms its previous decision, it needs to consider what size of programme should be pursued and whether, in principle, it should be financed from borrowing or from surpluses generated by the HRA. By making in-principle decisions on these issues, Members will assist officers in moving forward with recommendations on the size and composition of the loan portfolio. Decisions on obtaining a credit rating and the use of external treasury advice are also required.

<u>Building New Affordable Council Homes</u>

2. At its meeting held on 1 February 2010, the Cabinet considered a report from the

Affordable Housing Sub-Group established by the Housing Scrutiny Panel, which included proposals for the commencement of a modest new affordable house-building programme by the Council - primarily on small difficult-to-let garage sites on Council-owned, HRA land - following policy changes and the removal of financial disincentives by the Government.

3. The Cabinet agreed, in principle, to embark on such a programme, but that it should not be undertaken until the detrimental financial effect that it would have had at that time on the Council's General Fund no longer exists or was only minimal.

4. The main benefits to the Council of a new house-building programme would be that:

- Its HRA land could be developed for much-needed affordable housing (with 5,300 applicants currently on the Housing Register);

- The land and constructed buildings would be retained as a Council asset - rather than transferring the land to a housing association at a subsidised price;

- The Council would benefit from the net rental income in the future, once the development loan had been covered;

- It may be possible for the Council to receive the benefit of capital grant funding from the Homes and Communities Agency;

- The Council would have greater control over the future use of the affordable homes; and

- It would enable the Council to increase its housing stock, instead of continuing to reduce the stock through the Right to Buy, and thereby slowly reduce the associated unit costs of managing and maintaining the Council's housing stock.

5. Since the time the Cabinet last considered this issue in 2010, due to the mandatory introduction of self-financing for the HRA from April 2012, the detrimental effect on the General Fund may no longer apply. Therefore, it is considered appropriate for the Cabinet to consider whether or not, in principle, it wishes to explore the opportunity further and would like officers to undertake detailed considerations of the financial viability and how such a programme could be implemented.

6. An indicative 30 year business plan has been prepared to establish whether the level of borrowing proposed under self financing is sustainable for the HRA. The plan made some simplifying assumptions about the loans and the Council's ability to repay them, but for illustrative purposes showed that full repayment could be made in year 17 and that the HRA would then go on to accumulate substantial balances. The plan assumed that borrowing would only be at the level required to make the payment to buy the Council out of the subsidy system and that all funds generated would be used to repay debt as early as possible. The Housing Scrutiny Panel, which considers the HRA Business Plan in detail each year, will be considering a new HRA Financial Plan at its meeting in October 2011, and will be recommending a proposed new Financial Plan to the Cabinet in December 2011.

7. If the Council decided to pursue a programme of new house building, and to do it at the earliest opportunity, this could be funded from additional borrowing. Whilst the exact payment to leave the subsidy system and the exact borrowing limits are still to be determined, the latest figures from the Department for Communities and Local Government indicate that the Council will have a "Debt Cap" which could exceed the settlement payment by £23million. So for example, if the settlement was fixed at £180million and the Council wanted to spend £10million on building new homes it could choose to do this by borrowing £190million.

8. As an alternative to additional initial borrowing, the Council might decide that new homes should be built but only when finance was available from HRA surpluses. This could be done either once the loans have been repaid or rather than devoting all surpluses to debt repayment an amount could be set aside each year for a new build fund. For example, the 30 year plan shows debt repayments in the first five years of £17.8million, but Members could decide that only £7.8million should be used for debt repayment and £10million could be made available to fund new housing.

9. As an indication of the potential funding requirements, early and indicative appraisals suggest that, if a maximum of 20 new affordable homes were built each year, finance of around £2.5m per annum would be required from 2013/14 for the duration of the programme. If a four year programme was agreed in principle this would equate to £10 million of funding.

10. In weighing up the advantages (set out above) and disadvantages of a new build programme, there appear to be far more advantages than disadvantages. The main disadvantages are that the Council would hold debt and pay interest for longer, although it is explained below why it may not be in the Council's best interests to return to being debt free as soon as is possible, and the usual risks of undertaking a construction programme.

11. A further financial advantage is that the Government has made it clear that any payment it receives from councils under self-financing will not be full and final and may be revisited in the future. This could mean that any councils that repay their debt quickly could then suffer a further allocation of debt.

12. Members have previously confirmed the requirement that new capital investments should be revenue generating. Therefore, it is questionable whether the developments would take place if they were to be funded by grants to housing associations which left the Council without any asset. If it is assumed that any new build scheme is development that would not otherwise have happened, there is a potential benefit to the General Fund through the New Homes Bonus. The New Homes Bonus is based on the increase in the number of properties in the district, with an additional premium being payable for social housing.

13. A new house-building programme would be a significant undertaking by the Council and careful consideration would need to be given to the viability and implementation. For example, it is likely that a housing association would need to be appointed, through a competitive process, to act as the Council's Development Agent. Suitable sites would also need to be identified, which is currently in progress.

14. It is therefore suggested that the Housing Scrutiny Panel be asked to consider the detailed issues relating to the feasibility of undertaking, and the best way of implementing, such a programme and to make recommendations to the Cabinet accordingly.

Credit Rating

15. The PWLB has historically been the cheapest source of borrowing for local authorities. However, the Chancellor of the Exchequer increased the margin charged by the PWLB and it now appears that cheaper sources of finance may exist. Current indicative pricing for ten year loans shows a PWLB interest rate of 4.4% compared to a ten year bond at 4% and a private placement between 4 and 4.25%. For a £150million bond issuance costs could be as much as £850,000, although this would be a one-off initial cost and would be vastly outweighed if funding could be secured at 4% instead of 4.4%.

16. For a bond issued by the Council to be attractive to investors the Council would need to obtain a credit rating. If a credit rating was not obtained it might still be possible to issue a bond but the bond would be seen as riskier and this would result in a higher rate of interest. There are three rating agencies, Moody's, Standard and Poor's and Fitch's, although Fitch's are a smaller agency and for a rating to have the most impact it would need to be from one of the two main agencies. Preliminary discussions have been held with the two major rating

agencies and it is likely that an initial rating would cost approximately £20,000. If Members agree that a credit rating should be obtained, it is proposed to seek written quotes from both the major agencies.

External Advice

17. Borrowing £200million and determining the repayment profile, the number of loans the proportion of fixed interest against variable and the other key variables will not be easy. These are large complex transactions and if poor decisions are made the impacts are likely to run over many years and be very costly. For officers to be best placed to make appropriate recommendations to Members it is essential that expert external advice is obtained.

18. The Council uses Consult CIH to help with the HRA Business Plan and Arlingclose to advise on Treasury Management. As the proposals for self financing have been taken forward discussions with these advisers have been ongoing. Consult CIH have provided work of a high standard previously and have quoted £10,125 for business planning work to develop the 30 year model incorporating the borrowing implications. Arlingclose were originally appointed to advise on treasury management and investments, although they do provide advice on debt structures and borrowing to their clients who have loan portfolios. Arlingclose have quoted a price of £7,200 for the initial work necessary on creating the loan portfolio and, similarly to Consult CIH, their work has proven to be of a high quality and represent good value for money.

19. The cost of the initial credit rating (£20,000) and the business planning and treasury advice (£17,325) would be £37,325. However, it is anticipated that further costs will be incurred in this process and so to provide some head room a supplementary HRA revenue estimate of £50,000 is proposed.

20. Contract Standing Orders (CSO) set out the minimum requirements for the number of quotes that should be obtained for contracts of any given value. The requirements for contracts not exceeding £50,000 are set out in CSO 3 and 4 and contracts with a value between £10,001 and £15,000 require at least two quotes and those between £15,001 and £50,000 require at least three quotes. For the consultancy and treasury management advice it is proposed to continue with our existing advisors, as set out above. Alternative quotes could be obtained but this would delay the process and any new advisor would have time and costs in familiarising themselves with the Council's position. For the credit rating it is only proposed to obtain two quotes as whilst there are three credit rating agencies one of them is less well regarded and a rating from them would be unlikely to have the same standing.

Resource Implications:

The HRA has some £5.9 million in revenue balances as at 31 March 2011 and so the supplementary estimate proposed is clearly affordable. It is necessary to spend some revenue resource now to ensure that the Council has the best information and advice on which to base key financial decisions. If incorrect decisions are made on how the Council funds self financing they could be very costly.

The level of borrowing could be reduced by using the HRA revenue balance or usable capital receipts to pay part of the self financing settlement. As stated above the HRA revenue balance is currently £5.9 million and as the rate of interest earned on this will be less than the rate of interest payable on the borrowing there is an argument for using these reserves.

Utilising usable capital receipts to reduce borrowing is a more complex issue. The balance on the usable capital receipts reserve is currently £18.7 million, although over the life of the capital programme to 2014/15 this is predicted to reduce to approximately £9 million. These receipts can be used for general fund capital schemes and so their use in the HRA settlement will bring forward the date at which it is necessary to borrow to finance General Fund capital schemes. This will have the impact of increasing revenue costs in the General Fund.

Members could decide that house building should be funded from S106 contributions from developers for affordable housing. A number of substantial contributions have been received in the past but these have been used to fund developments with housing associations.

Currently the only S106 money held for affordable housing is £435,000 which was received from McCarthy & Stone, although this has already been allocated to fund an affordable housing scheme. Whilst it would be worth applying any new S106 money to support a new build programme, it is unlikely that sufficient S106 funds will be available to completely pay for such a programme.

Legal and Governance Implications:

The power to dismantle the existing Housing Subsidy system and to force Councils into self financing is included in the Localism Bill which is currently going through Parliament.

Safer, Cleaner, Greener Implications:

There are no environmental implications.

Consultation Undertaken:

Consultation is ongoing with other local authorities and DCLG. Discussions have also taken place with Consult CIH, Arlingclose, NatWest Bank, Barclays Capital, Moody's and Standard and Poor's.

Background Papers:

Previous reports on self financing.

Impact Assessments:

Risk Management
This report touches on a number of risks included in the Corporate Risk Register:

(a) Risk 11 – Unable to provide sufficient housing for local people;

(b) Risk 17 – Significant amount of capital receipts spent on nonrevenue generating assets; and

(c) Risk 33 – Reform of Housing Revenue Account.

If the Council decides not to build any new housing it is likely to be seen as failing to deal with the shortage of affordable housing in the district.

If the Council is viewed by DCLG as repaying debt too quickly, the settlement could be re-visited and additional debt allocated to the Council.

If appropriate external advice is not obtained there is a risk that poor decisions may be made on the business plan and borrowing portfolio which could prove costly for the Council.

Equality and Diversity:

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?	No

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