



HRA Reform: Council Housing - a real future CIH Briefing

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Introduction

CLG published its long-awaited voluntary 'offer' to local authority landlords on 25 March. The offer is in the form of a prospectus setting out the terms on which the government plans to implement the dismantling of the Housing Revenue Account (HRA) subsidy system and introduce a system of self-financing from April 2011, on a voluntary basis.

The offer has been keenly anticipated by local authorities since many responded to the consultation paper on the outcome of the HRA review in July 2009 by expressing concern that a legislated settlement might take a number of years to complete. The intention is to utilise the powers within the Housing and Regeneration Act 2008 to implement self-financing for all properties in the HRA. Already, these powers are being used to hold newly built HRA properties outside the subsidy arrangements.

This briefing sets out CIH's initial analysis of the proposals made on 25 March, the terms of the offer, and its impact in national and local policy terms.

It is intended to assist authorities, ALMOs and their stakeholders to understand what is 'on the table'; offer pointers for the modelling they need to undertake; and to highlight areas where they might wish to focus their responses to the proposals. It is organised by the main headings within the prospectus.

Overall assessment of the offer

CIH's *overall* assessment of the government's offer is:

CIH welcomes the proposal to dismantle the outdated and unfit-for-purpose HRA subsidy system. We have worked closely with many authorities, with other agencies and government over many years to advance proposals to this point and believe that the moment has come to make this vital reform. The move is consistent with the aspirations of tenants, the need for greater efficiency in the use of resources and the move to cross-domain regulation from the Tenant Services Authority with its emphasis on more local control, more local offers and active tenant empowerment in planning and decision-making. It is also an essential reform towards achieving the government objective of building more council homes.

CIH further recognises that in the tight fiscal climate, the government may feel it has no choice but to restrict capital investment through capital grants and also through borrowing. This is understandable but also represents a challenge. We want to work actively with government and stakeholders across the sector to enable investment to be undertaken to complete the decent homes programme, address other backlogs of improvements works, to regenerate those areas in need of investment and to develop a long-term role for new council housing to meet new housing needs.

The deal and capacity

The key thing to recognise about the prospectus is that it represents a 'deal': a deal between national and local government as a whole and with individual local authorities in terms of their settlement. It depends on all – or the vast majority – of stock-retaining councils accepting the deal when it takes its final form.

As almost everyone acknowledges, the current system is long past its 'sell-by' date and no longer delivers what a modern, effective system of finance requires. The recent move into producing a national surplus (or 'tenant tax') has angered many and really focused attention on what would happen if nothing changed.

At the same time, since the self-financing pilot project was begun in 2006 and concluded the majority of its work in the summer of 2007, the public expenditure climate has worsened considerably. This is significant in that the 'deal' has been negotiated against the backdrop of major uncertainties about future public expenditure levels and what will happen at the end of the current spending review period (March 2011).

There are therefore aspects of the 'deal' that are better than expected and there are also some downsides. A summary of the main components is set out below.

Debt allocation

The overall national deal is to allocate £25.1bn of debt between 177 authorities as the value of the council housing business, using an assumption of future rents and uplifted allowances. The projected subsidised level of debt as at 31 March 2011 is £21.5bn. The 'price' of departure to local authorities for dismantling the system might therefore be said to be £3.6bn.

However, the uplifted allowances on which the deal will be based represent, as far as government budgets are concerned, significant real-terms increases in expenditure on council housing. They equate to increases of over 5% in management and maintenance and over 28% for future major repairs, increases on a scale which are simply not being contemplated in any other part of the public sector.

On the face of it, the debt allocation looks difficult. CIH and others have consistently called for the full amount of future rent income to be available to local HRAs and therefore only current debt levels to be reallocated in any settlement. In the event, the 'deal' takes a view towards splitting future net revenues nationally and locally as follows:

1. If the subsidy system were to continue in its current form with current policies towards financing and allowances, the value to the government of all the future net revenue surpluses (i.e. negative subsidy) is estimated at £13bn over 30 years. This is after the servicing of around £20-21bn of debt.

2. Simply put, the prospectus proposes that the benefit of the forecast surplus be split: £3.6bn is paid to central government 'up front,' and around £9.4bn is retained within local HRAs.

Despite the fact that this proposal means a proportion of expected surpluses remaining with the government, it is in fact an improvement on what was likely to have been the deal last year. Although the full sums were never published, informed estimates of the position (had the proposals from last summer's consultation been implemented as they stood) suggested that the debt allocation might have been as high as £7bn more than current debt levels.

In the current climate therefore, CIH believes that, whilst not perfect, the proposed deal is better than could have been expected and gives substantial extra spending power in a self-financing HRA that would not be available in a continued national system.

New build and the discount factor

The use of the discount factor is important (see below for more detail on the technicalities). The increase in the factor from 6.5% to 7% reduces the allocation of debt by around £1.2bn. In other words, the deal would have been a debt allocation of £26.3bn had it not been for the proposed change to the discount factor.

In the prospectus, this change is explicitly linked to delivering headroom for new build council housing; the issues about how this might work are explored in more detail below.

The discount factor is higher than recent stock transfers and would be subject to confirmation in the next spending review period but is extremely significant in the current economic climate. This represents a clear and unambiguous commitment to develop the role for councils to directly deliver new housing in numbers which have not been seen since the late 1970s. Certainly, the over-subscription of the recent two rounds of bidding for HRA new build under *Building Britain's Future* will have helped convince government that there is the appetite for more delivery. Clearly also the commitment should be seen in the context of the recession and delivering better value for investment through the HCA (using existing housing land with more straightforward planning applications, for example).

CIH very much welcomes the commitment within this proposed settlement to a long-term and meaningful contribution of new council housing to meeting future needs. The discount factor mechanism is a little complex but we urge authorities to work positively to identify opportunities as a result of the additional headroom it creates.

Capital grants (and ALMO funding)

The government has made a welcome commitment to fund the balance of the decent homes programme for ALMOs, about which there has been considerable concern.

Nevertheless the overall proposals for grant funding are disappointing and, in particular, their lack clarity in terms of what the grants will finance, future processes for bidding and how grants will be accessed. Their apparent restriction to a level of £3.2bn is particularly disappointing as there is overwhelming evidence that there are backlogs of investment in areas additional to the Decent Homes Standard.

This disadvantage is to some extent mitigated by the closeness of the debt allocation to current debt and the explicit commitment to the completion of the decent homes programme. CIH and others have nevertheless called for a lower debt settlement rather than reliance on future capital grants which are uncertain, especially in the current climate. There does appear to be some recognition in this reduced debt allocation but at the same time the crucial issue is whether future capital funding will be sufficient.

We recognise the difficulty of the economic and public expenditure climate. We also know that successive governments have acted to cut investment (capital expenditure) during recessions.

CIH urges the government not to close the door on the provision of future capital grants and to be clearer about what they might be for and the process for accessing them. We want to work positively with the government and the sector to ensure that we do not lose sight of the need to clear the remaining backlog, which after all has been a government commitment since April 2000.

Borrowing

The government has proposed that borrowing be limited to opening debt levels. This appears to be part of the deal in which the discount factor has been increased and debt allocation reduced below what it might have been. There is however scope within the settlement to revisit future borrowing policies and it is important that this scope is maintained.

CIH regrets the absolute restriction on borrowing as this might prevent necessary investment to improve future efficiency. We want to work closely with the government and the sector to develop a sensible and manageable approach to future borrowing policies which draw upon the best aspects of experiences from the housing association sector.

Capacity building

In its introduction, the prospectus recognises the need to build capacity within the sector, particularly in the critical areas of financial and business planning, long-term asset management and, for current low debt authorities, treasury management capacity.

CIH and the LGA, with the support of the IDeA, CIPFA's Housing Advisory Network and the Northern Housing Consortium will be running events aimed at disseminating guidance and stimulating discussion around the prospectus, focusing on the needs

of officers, members and tenants in local authorities. We also intend to publish guidance on detailed interpretation of the prospectus in the next few weeks.

We are particularly interested to encourage involvement of tenants in the development of long-term asset management and business plans. Whilst there is a key role for tenants in influencing and responding to this proposal, a successful future will depend on the meaningful empowerment of tenants in shaping business plans: how to spend the rental income, whether to prioritise between investment in existing stock or new build, what kind of efficiencies can be delivered to increase future resources and investment – and other major strategic choices.

CIH believes that localising decision-making and significantly enhancing tenant involvement go hand-in-hand.

Detailed components of the deal

The proposed debt settlement is arrived at through a Net Present Value (NPV) calculation of future net revenue streams based on subsidy allowances, as uplifted as a result of the research that has been undertaken. The core components in the calculation are listed in turn below.

A critical factor for the assessment of the settlement is the fact that the assumptions have been rolled forward to 2011/12, using 2.5% as the inflation measure from 2010/11 to 2011/12.

Authorities should therefore compare the proposed change in debt interest charge (using a rate appropriate to their local circumstances) with the level of subsidy predicted as at 2011/12 with current allowances. In almost all cases, authorities should find that their negative subsidy would have gone up (or positive subsidy gone down) for 2011/12.

Rent income

The core assumption is that guideline rents will increase by 2.2% above inflation on average until 2011/12 and then converge to formula rents by 2015/16. Formula rents will increase by 0.5% above inflation every year.

Adjustments relating to caps and limits (where rents have previously been limited through the operation of the RPI+0.5%+£2 limit on individual rent increases) have been applied in the calculation. The impact is to slightly reduce debt settlements. As caps and limits adjustments apply at the individual property level, the figures in the settlement proposals can only be estimates and there is a risk that some caps and limits might be understated.

Authorities might therefore forward forecast their rent increases at the individual property level using core inflation of 2.5% or 2.75% in order to determine the impacts of caps and limits at the individual property level. If the limit on increases is higher than implied in the settlement calculation, authorities may wish to include this in their response.

The main policy issue associated with the income assumptions in the settlement is that the government has had to commit itself to an assumption of future rents for 30 years. Recent history shows that government has often intervened in rent policies, varying increases and convergence periods on an annual basis. The commitment to directing policy through the TSA is a positive move in bringing the council housing sector into line with housing associations. Authorities should also note that the limit rent mechanism is proposed to continue with CLG presumably continuing to take a role in setting average limit rents at the authority level and DWP claiming any excess.

CIH welcomes the commitment to a future rent policy which is predictable and where government does not direct the TSA to intervene annually. It is essential that authorities are allowed to plan ahead on the basis of the assumed rent policies in the final settlement.

Management and maintenance

The core proposal is to increase allowances by 5.4% varied according to regional and other factors, including those for high-rise and other flats. The research undertaken for the HRA review and included within the original consultation identified a need for a 10% increase in allowances to bring them into line with housing associations, and the government committed itself to a 5% increase. Generally, the work undertaken for the prospectus has rolled forward two years and arrived at a slightly higher increase but taking account of inflation.

Overall, the distribution of uplifts favours authorities in London and those with larger stock portfolios; uplifts vary between zero and 13% by authority.

Major Repairs Allowance

Research was undertaken in the HRA review which identified significant under-funding of the MRA arising from increased future needs, following the achievement of the Decent Homes Standard. The work undertaken for the settlement updates the original proposal and results in an average uplift of just over 28%.

Variations arise as a result of stock mix, with the higher uplifts focused on those authorities with a greater proportion of houses; variations are between authorities range from 5% to over 50%.

The national average MRA utilised in the calculation is £912 per unit. Over a 30-year period, this equates to just over £27,000 per unit at today's prices. As a quantum of resource over the lifetime of a 30-year business plan, therefore, the MRA is not far off benchmarks in terms of stock condition survey outputs.

Nevertheless, the MRA remains below the level required for capital investment needs in most authorities as it does not include common areas, improvements and backlogs. These are intended to be provided for through the proposed system of capital grants (see below).

In the current system, actual M&M allowances vary from a target allowance. For most, the differences between actual and target allowances are small. However for a small number of authorities, actual allowances remain well above target following the change to formulae implemented in 2004/05. Authorities should note that the assumptions of allowances in the settlement calculation are based on 'target allowances' and protection for those above target is consolidated within a view taken across all three expenditure allowances.

Consolidation of the allowances

Perhaps the most significant aspect of the uplift methodology applied at the individual property level is the move to consolidate all three allowances into an overall measure of uplift (management, maintenance and major repairs together). This has the effect of smoothing out wide variations and resulting in increases which vary between 6% and 15%. As set out in the prospectus, all authorities are then protected by setting a minimum 10% increase across the three allowances, leading to a relatively even distribution of uplifted allowances across the country.

In summary, the total increase in allowances is around 13% or £500m in revenue spending power across the system.

CIH welcomes the commitment to provide for increased management, maintenance and major repairs costs in the settlement which will provide authorities with more spending power from day one of the new system, and for these increases to be set at a minimum level for each authority.

Application of inflation

The NPV calculation for the debt settlement is based on a 'real terms' cashflow, i.e. that all figures are at 2011/12 prices. This is in line with stock transfer valuations since 1990.

As rents are always above the level of day-to-day revenue spending, in *financial terms*, higher inflation benefits the business plan. The impact for future business planning is significant in that the use of a 'real' discount factor means the value of all future net increases in inflation are available to the HRA in the future.

CIH welcomes the acknowledgement in the settlement that the benefit of headroom built up over time through inflation should be available to business plans locally and for the benefit of tenants.

Discount factor and new build

The discount factor (the percentage rate required to calculate the present value of a future cash flow) used in the NPV calculation is intended to reflect a 'cost of borrowing'. The choice of discount rate is extremely significant in the valuation of the business and therefore the amount of debt to be allocated, individually and

nationally. The higher the rate, the lower the debt that can be afforded, therefore the lower the valuation.

In stock transfers, private funders have always insisted on the use of a factor which is above the current level of interest on borrowing in the market. This provides for some leeway in the delivery of the business plan.

CIH welcomes the government's acceptance of a similar rate of discount as for stock transfers in the proposed HRA settlement.

Recent stock transfers have taken place using a 6.5% discount factor. This appears to be the core settlement calculation within the prospectus reflected in the guidance and modelling carried out for the settlement. When combined with the rent and allowance assumptions above, the use of this discount rate leads to an overall valuation of the HRA business of around £26.3bn, the total debt allocation for all authorities.

It is not yet completely clear how the reference to a higher discount rate of 7% and the use of the additional headroom for new build 'in five years' is intended to be implemented. Key questions include:

- If an authority is unwilling or unable to commit to new build, would their settlement be at the 6.5% rate (i.e. higher debt)?
- If the lower 7% settlement is implemented, will this be clawed back if properties are not built within five years? How could or would this be monitored?
- How can authorities usefully model the headroom for new build? The reference in paragraph 3.32 to 'paying off debt from day one' to build up headroom to enable new build in five years appears oblique. What would this mean in practice – and would there be an expectation that this would be done?
- What role could the headroom between actual debt and current subsidised debt (retained in the new system) play in providing for new build?
- What is the position if an authority has not achieved decent homes and the clear local priority of tenants and members would be to use the headroom for decent homes expenditure?

These and other issues remain to be resolved and we will issue further clarification when we have received it. In the meantime, our working assumption is that the settlement will be at 7% and that authorities should aim to give an indication of how many new properties could be delivered given the debt differential. It is not straightforward. Two example calculations are shown below.

Example headroom calculations

Assumptions:

- 6.5% leads to a debt settlement of £135m.
- 7% leads to a debt settlement of £128m.

Assume build cost at £100k and social housing grant at 50% of build cost (by no means guaranteed in the future).

Example 1: use of debt headroom for new build
£7m of borrowing matched by 50% SHG gives scope to deliver 140 new properties in total.

Example 2: pay down debt using headroom and 're-borrow'
At 6% interest rate, the 'saved' interest is £7m x 6% = £420k per annum. This enables the 'repayment' of £2.1m debt over five years, therefore enable 42 properties per year to be built by year 5.

Enquiries to CLG officials suggest that it is up to authorities to determine how they might best use the headroom for new supply. Our advice therefore is to develop some outline thinking about numbers and timing along either of the lines above.

CIH very much welcomes the commitment to build new homes using some or all of the headroom in the proposed settlement. We believe that many authorities will respond positively to the ability to deliver new housing.

Our strong advice to authorities is to present outline plans for new build numbers using either the capital or revenue impact of the debt differential between the 6.5% and 7% discount factors.

Further clarification is required on the various references made to 10,000 new properties per year given that the headroom provided in the proposed settlement might in some instances only be used once.

Backlog and capital grants

The prospectus confirms that a system of capital grants will be put in place to enable the completion of backlog works to council housing. We recognise that the economic and public expenditure position is extremely challenging and realise that the lack of a firm commitment to funding capital grants was to be expected, particularly in the context of a new spending review period starting in April 2011.

However, even while recognising the tight fiscal position, there are some uncertainties around the commitments made to funding for capital grants which require clarification.

What is the backlog? The prospectus refers to £3.2bn to 'complete decent homes for ALMOs'. It is also noted that this is close to (but not as much as) the additional debt allocated as part of the proposed settlement. Yet there are multiple other backlogs, for example:

- Decent Homes works in a minority of retained-management authorities (a small number of which are experiencing significant difficulties in completing the standard)
- Other improvements around flatted estates and the wider environment
- Exceptional works to non-traditionally built properties

- Dealing with obsolete sheltered housing
- Regeneration of estates.

The 2009 consultation paper identified an improvement backlog of £6bn. Does the reference in the prospectus therefore mean that the government is no longer prepared to finance this amount or that their estimates have changed? In addition, the financing for aids and adaptations, widely acknowledged to need increasing, is absent in the prospectus as is overt provision for other health & safety works.

It may be that the CLG considers there will be sufficient headroom in the revenue settlement to enable this investment to be brought forward in due course, and there is no doubt much greater ability to deliver investment as a result of that headroom. The key issue is therefore clarity about what is intended.

Authorities should compare their own stock survey capital profiles with the ability of the self-financing plan to deliver investment. Such an exercise will enable them to identify the areas and years in which there is under-funding. Our advice is that only in a limited number of circumstances might authorities be realistically able to factor in capital grants in addition to the revenue resources generated within their plans.

CIH welcomes the proposal to put in place a system of grants to finance remaining backlogs of stock improvements and understands that the government is unable to make cast-iron commitments in advance of a spending review and given the tight fiscal position. However, the Decent Homes programme must be completed. In addition, there needs to be more clarification on what is meant by backlog, how the £3.2bn commitment made in the prospectus relates to the £6bn referred to in the previous consultation paper, the government's proposals for access and distribution to both ALMO and non-ALMO authorities, and how the government intends to finance other adaptations and health & safety works also identified as necessary.

Borrowing

Also as a result of the tight national fiscal position, the government has proposed to cap future HRA borrowing at the level of the opening debt settlement. It had been expected that the settlement might come with an 'initial debt profile' which allowed some headroom for additional borrowing in the early years post-settlement, and indeed the supporting documentation and model appear to assume such an approach.

It may be that the cap was proposed as a result of the allocation of a lower debt amount (due to the higher discount factor); however it was arrived at, the imposition of such a cap does at least provide for medium-term clarity over what can and cannot be borrowed within self-financing plans and avoids annual determinations of borrowing levels (which might have been the alternative approach).

Authorities will retain the current headroom that many have if their actual level of HRA debt (HRA Capital Financing Requirement) is lower than the Subsidy Capital Financing Requirement. The improvement in the revenue position for all HRAs should make 'borrowing up to the limit' more affordable. For many authorities this

headroom is significant and at the national level, the headroom is in the £ billions. Authorities might also consider utilising this headroom to meet the request in the prospectus to bring forward new build plans.

Nevertheless, the imposition of a cap on borrowing undermines the principles within the Prudential Code and could artificially constrain 'spend to save' type investment where up front spending is repaid from future revenue streams. Examples of schemes which might be restricted could include borrowing to pump prime regeneration schemes which generate future sales and improved rental income. In short, the scope for active asset management will be restricted, particularly in the early period.

A further difficulty arises for the minority of authorities which have prudentially borrowed to meet the Decent Homes Standard. Their investment will not be recognised in this settlement.

CIH regrets that the government has found it necessary to impose a cap on borrowing but recognises that for as long as HRA borrowing is classified in the present way, there is a legitimate interest from government in exercising some form of control. CIH would have preferred a more sensible long-term approach around the development of suitable ratios and covenants similar to those in operation in the housing association sector.

The proposed approach will artificially limit 'spend to save' type investment and could lead to delays to regeneration and redevelopment schemes and other much-needed investment which would contribute positively to the government's housing objectives. CIH looks forward to working with government to develop a longer-term approach to managing borrowing and debt which enables sensible and much-needed investment and recognises that borrowing through self-financed HRAs should be treated differently.

Authorities should note that prudential borrowing undertaken as part of the two recent rounds of council house building (*Building Britain's Future*) might also affect the use of headroom between Subsidy CFR and HRACFR. In effect, if the peak debt is the debt settlement, some of that headroom has already been used up. The total to be borrowed nationally under this programme is in the region of £200m. As this is a programme to deliver new build outside the current subsidy system, it is not appropriate to restrict this borrowing beneath the new cap.

CIH calls on the government to recognise that the amount of approved prudential borrowing undertaken in the Building Britain's Future programme is outside current subsidy arrangements and that this borrowing should be added to the opening debt settlement to determine 'peak debt'.

As set out above, for as long as HRA borrowing is publically funded, there will be a need to accept central government control. A truly long-term solution would be to achieve the reclassification of HRA borrowing as outside general government expenditure. Now might be a good time to re-engage in this debate, particularly as

there is a settlement which is passing the responsibility for the servicing of the debt settlement to local authorities. CIH is therefore continuing the campaign to achieve reclassification so that authorities and ALMOs can develop meaningful long-term asset management strategies.

Right to buy receipts

The prospectus confirms proposals to allow authorities to retain 100% of right to buy receipts, split 25% for any capital use (as now) and 75% for affordable housing and regeneration. The government proposes that authorities provide formal details of how they have committed receipts to capital programmes (or the repayment of debt). They have not continued with the proposal consulted on last year to direct the use of receipts.

It should be noted that a proportion of RTB receipts must be allocated to the HRA following a disposal. This is to recognise that the debt associated with the property no longer has an income stream to service it. We suggest that a minimum allocation of RTB receipt should be the unit opening debt for properties in the HRA. Further allocation to the HRA would be an issue for the housing strategy and made in the context of an overall asset management strategy. For some authorities, 100% allocation of RTB receipts to the HRA will be appropriate, others may take a different view.

It is tempting to suggest that given the current low level of RTB sales that the additional spending power delivered will be limited. Our experience is however that the additional capacity for reinvestment enabled by RTB receipts should not be under-estimated by authorities.

CIH welcomes the proposal to retain receipts locally and that the government will allow authorities and their stakeholders to determine their usage. Such a move is long overdue and, as we have stated publically before, could and should be brought forward in advance of the revenue settlement.

Technical issues

With regard to the technical, accounting and debt management aspects of the proposals, there is a strong sense of increased transparency around the future operation of the HRA. This is also consistent with cross-domain regulation and the role of the Tenant Services Authority and the move within the new regulatory framework to encourage a much greater role for tenants in planning the future and scrutinising the present.

CIH welcomes the direction of travel towards greater transparency for the HRA as this will encourage and enable greater tenant empowerment in shaping future business plans.

The key areas are the development of an HRA balance sheet, the continued need for depreciation and the operation of some form of reserve for future major repairs,

the options for greater earmarking of HRA debt and the updated guidance around the operation of the ring fence.

HRA balance sheet

The proposal is to develop a memorandum balance sheet for the HRA. It will not be a statutory account but a requirement to report as part of the annual report of the council. This will identify asset valuations and long-term debt liabilities and promises therefore to ratchet up the understanding of the way in which stock and assets are being used.

Balance sheet information will enable more meaningful comparisons across domain and should in time highlight the extent of the additional capacity for investment within council housing.

CIH welcomes the introduction of a memorandum HRA balance sheet. There will be a need for training of officers, members, ALMO boards and tenants in making use of the information and CIH urges government and TSA to bring forward resources to enable such training.

Depreciation and debt repayment

The prospectus proposes that an appropriate policy towards depreciation is adopted in line with standard accounting practice. The impending implementation of International Financial Reporting Standards (IFRS) is relevant in this context and it is important that corporate and housing accountants understand the requirements for making a fair depreciation charge to the HRA.

One approach might be to make a depreciation charge based on the MRA calculation undertaken in the settlement; this would have the advantage of being based on 'component lifetimes' and should not put the self-financing HRA under undue additional resource pressure after the settlement. However, authorities should recognise that the condition and life of some properties might occasion a greater charge for depreciation and impairment than that identified in the 'MRA calculation' and work to understand the implications will be required.

However the charge is made, it is essential that it is 'cash backed' and set aside either for future renewals, major repairs or debt repayment. A form of renewals reserve along the lines of the Major Repairs Reserve will therefore be required. Many authorities have accepted the need for such a reserve in their new build plans. Such a reserve will also help to ensure that appropriate resources are allocated for future capital repairs, rather than reserves building up in revenue (which might offer temptations to diversion elsewhere).

Providing an appropriate depreciation policy is observed, there is then no statutory or government requirement for debt set aside (Minimum Revenue Provision), the theory being that maintaining properties in lettable condition will enhance their value and therefore there is no absolute need to redeem debt.

CIH believes CIPFA and the Audit Commission should work together to develop guidance around future charging for depreciation so as to maximise the efficient use of resources whilst meeting international accounting standards.

Treatment of borrowing and debt

Traditionally, local authorities have held all of their debt in one single 'pool' across all services. With the introduction of self-financing for the HRA, the government is seeking to encourage authorities to separate the debt and therefore increase the transparency around the costs of debt charges to tenants (as opposed to council taxpayers). The move is also consistent with the implementation of cross-domain TSA regulation and assists in making comparisons across sectors.

The separation of debt as 'HRA debt' might also act as comfort to other services within the council in that there could be an explicit connection between the HRA debt and a requirement for the HRA to service that debt. This would be an important move as it would prevent calls on council tax to help service HRA debt.

Nevertheless, the issues around the separation or earmarking of HRA debt are complex, not least because they would be addressing precedents that have built up over many years and might involve the physical separation of loans which were originally of dual purpose. Treasury management specialists will need to be involved in advising in more detail on how best to move to greater separation and there may be more than one option going forward. Conditions might be very different in different authorities. Authorities are advised to ensure that their Treasury Management officers have a very clear role in assessing the implication of the prospectus.

CIH supports the move to encourage greater separation of debt and debt accounting for the HRA as part of a general move to greater transparency. However, it is essential that corporate finance officers are integral to the process of change and that, where possible, authorities are able to exercise local flexibility in the management of their debt.

Ring fence

The prospectus also contains updated draft guidance on the operation of the HRA ring fence. The fact that guidance has been issued is important given that there needs to be greater clarity around which account is charged or what costs when the HRA will be better-resourced. The draft paper is essentially aimed at improving transparency and is therefore welcome.

The list of services and their proposed classification as core, core-plus and non-core is an interesting addition to the paperwork. We wonder whether this is helpful given that the key objective within the ring fence arrangements is to seek greater transparency and within this, greater flexibility to respond to different housing conditions in different areas, as opposed to a rigid classification of different types of service expenditure. It will be for authorities and ALMOs to determine their approach to the guidance and interpret how this impacts on their HRA and General Fund.

CIH supports the reissuing of guidance on the operation of the ring fence; this is long overdue and it could increase the transparency of charging and be used to inform constructive consultation with tenants and other stakeholders. We believe that the proper role for guidance is to encourage transparency as opposed to being directive about specific areas of contentiousness.

Other issues

No doubt individual authorities will raise many local issues in the coming weeks. Some of the key areas we have identified in addition to the key aspects set out above are addressed here.

HRA Private Finance Initiative schemes

Currently, the revenue finance to support contract payments for HRA PFI schemes is contained within the HRA subsidy system. The abolition of the system necessitates some change to the financing arrangements.

Despite advice to the contrary, the proposal in the prospectus is to roll up the existing PFI scheme payments into the debt settlement but not those as yet unsigned. Our preference, and that of other key agencies, was to maintain the PFI scheme finance separately for all PFI schemes and therefore bring it into line with other housing PFI funding within CLG. The government has accepted this case for new schemes but not for existing schemes.

The proposal leads to some outlying outcomes, with some of those authorities affected gaining a 'negative opening debt' result. It is by no means clear how such a proposal would work in practice.

CIH welcomes the long-term commitment to continue HRA PFI funding but we suggest there is a case for revisiting the prospectus on existing schemes given the additional complexities involved in the approach proposed. Authorities with existing PFI schemes are strongly advised to engage separately with CLG on the issues raised by the prospectus.

Risk transfer

There is a short passage on risk management in the prospectus and it is absolutely essential that authorities get to grips with the changed risk profile under self-financing.

Risks reduced under self-financing

These include the risks of changing future subsidy determinations (sometimes very late and very volatile) and the risk that Treasury/government would 'get used' to relying on the revenue surpluses from the system. In addition, the risk of political intervention through reopening the settlement is likely to be lower than annual political interference in subsidy determinations.

Risks unaffected

There remains the key risk (as to any business) that expenditure inflation is greater than income inflation; this is unchanged from the current system.

Risks taken on under self-financing

Risks around Treasury Management and interest rates will fall on to the HRA. The higher the debt and more mixed the portfolio, the lower the risk that short-term fluctuations in interest rate policy will materially affect the plan. There is also the risk that the passing of long-term capital and maintenance responsibility to local authorities (from central government) might not be accompanied by the capital resources required to get properties to the required standard in the first place. This latter point is critical and really emphasises the importance of government being much more explicit and open about the role of and process for future capital grants.

CIH recognises that the risks inherent in running a housing business will pass to local authorities and that these risks are best managed locally, with the support of local stakeholders, especially tenants. All authorities and ALMOs should enter into self-financing agreements with robust and up to date Risk Management Strategies and there is a real need for work in this area in the coming months.

Opening the settlement

As the settlement is voluntary in the sense that it will not be implemented through new legislation, the process will be subject to a self-financing agreement, under the terms of the Housing and Regeneration Act 2008. However, there is very little detail in the prospectus about what such an agreement might look like and the process for the developing the format. It should be noted that the government does not intend to enter into individual negotiations.

The prospectus makes reference to a 'full and final settlement' and it is certainly true that the subsidy system would be virtually impossible to put back together again if it were to be dismantled.

Nevertheless, there are references to circumstances in which the settlement might be revisited (in terms of the debt amount as opposed to the principles of self-financing). For example, these include changes in rent policy and changes to PFI funding. There are circumstances in which authorities might want their settlement revisited, the best example being if there are future caps on rent increases – this would mean that the HRA would not be able to generate the income assumed in the debt settlement.

CIH understands that the settlement may be able to be reopened and that for as long as council housing expenditure remains public expenditure there is a government interest in how resources are spent. However, we strongly believe that the circumstances in which it could be reopened should be explicit, limited and operate in both directions (for the benefit of councils and of government).

CIH calls on the government to begin the process of determining formats for self-financing agreement now and to publish more explicit material around the operation of these agreements in the run-up to the settlement date.

Your authority and the position of other authorities

As the proposed settlement is for the system (as opposed to individual authorities), there is a call for agreement by all authorities across the sector. Failure to secure agreement could mean that the process will be legislated for and it would be possible (some might say highly likely) that the financial terms of such a settlement would then be worse than the current offer.

However, it is by no means clear what the situation would be if a minority of authorities were unwilling or unable to accept the proposals on a voluntary basis.

All authorities are advised to examine the proposals carefully and to weigh up the advantages of revenue flexibilities, the downsides around capital finance and borrowing, the implications of the technical changes and the prospects for delivering new build with some of the additional headroom.

All authorities will be better off financially as a result of the settlement, particularly given that there is little certainty around capital finances even if the subsidy system stays in place. The key drivers here are the challenges around the public finances.

The general election outcome also might create uncertainty although it is as clear as it can be in the current climate that all three parties support a move to self-financing and that the issuing of the prospectus pre-election provides for a draft settlement that would not be easily undone.

The best advice is to 'watch this space' in terms of publicity, events and intelligence. CIH amongst others will keep authorities informed of progress.

What should you be doing?

The overwhelming need is for authorities to model the impact of the proposed settlement into their HRA business plans removing the line of HRA subsidy and incorporating a longer-term plan to meet capital needs (identified within the stock condition survey or other evidence).

Key sensitivities and scenarios will need to be developed to model the future; some (by no means all) are:

- The progress to rent restructuring (and implication of caps and limits adjustments)
- The investment needed in management and maintenance service costs in the context of the TSA's standards framework
- Inflation and interest rate sensitivities
- Scenarios around the volume and use of RTB receipts

- The application of different standards for stock improvement and investment
- Whether debt is paid down and re-borrowed or whether the plan is 'interest only'
- Property acquisitions and disposals
- The long-term scope for asset management and asset replacement.

This could be complex and needs to be explained to tenants and members to allow their influence and to facilitate their decision.

However, when informing the debate, a key bottom line test is relatively simple to apply.

What would the subsidy position have been in 2011/12?

This can be derived by de-uplifting the amounts for M&M and MRA from the first year of the subsidy forecast in the supporting model and adding back the subsidy debt charge.

What is the change in interest cost as a result of the debt adjustment?

This can be derived from the application of current rates (up to 6% say in some cases) to the debt adjustment in the supporting model.

The net effect of these two amounts is likely to deliver a year one improvement to the HRA's finances. How much is it? What could it be spent on? How could it be used to service existing stock and deliver support for new stock?

Responding to the consultation

The consultation questions are confined to six areas and are repeated below, with a summary of CIH's views, for easy reference.

1. What are your views on the proposed methodology for assessing income and spending needs under self-financing and for valuing each council's business?

CIH supports the general process and recognises that there has to be some basis for the dismantling of the system. The alternative would be 30 further such exercises of annual determination. We encourage authorities to review the uplift and rent assumptions and to highlight where the settlement methodology does not specifically address conditions locally. Examples might be around prevailing interest rates and limits on future rent increases.

2. What are your views on the proposals for the financial, regulatory and accounting framework for self-financing?

CIH supports the move to greater transparency in the operation of the HRA as part of a wider move to empower tenants and in the direction of travel towards cross-domain regulation and supports all elements of the regime which deliver greater transparency.

3. How much new supply could this settlement enable you to deliver, if combined with social housing grant?

Authorities are encouraged to focus on an analysis of the additional headroom in the settlement between the 6.5% and 7% discount factors and determine options around development using these resources (as capital, as revenue, or as borrowing headroom). Authorities should also consider how best to utilise the headroom between Subsidy CFR and HRA CFR in thinking through their new build options.

4. Do you favour a self-financing system for council housing or the continuation of a nationally redistributive system?

CIH strongly believes that the national redistributive system has become unworkable and no longer meets the needs of councils, ALMOs and their tenants. We therefore welcome the proposal to dismantle the HRA subsidy system as a matter of principle, and urge councils to indicate their views on this in their responses so that the overall view of local authorities is clear, to this and the next government.

5. Would you wish to proceed to early voluntary implementation of self-financing on the basis of the methodology and principles proposed in this document? Would you be ready to move to self-financing in 2011/12? If not, how much time do you think is required for implementation?

CIH encourages authorities to model and analyse the proposals carefully and in determining their response, think through the alternatives of a continued subsidy system (with no guarantee of uplifts) and a settlement imposed further down the line, almost certainly in an era of national financial constraint.

6. If you favour self-financing but do not wish to proceed on the basis of the proposals in this document, what are the reasons?

We believe that virtually all authorities will be better off in revenue terms as a result of the proposals. We are particularly keen to hear from authorities which do not feel that this is the case. It is of course a matter for individual authorities to determine whether they feel that the offer is 'good enough' to accept.

Please contact Steve Partridge on 07968 354948 or steve.partridge@cih.org to comment on this briefing.

For assistance in modelling, briefings, capacity building and with responses, please contact Steve and the ConsultCIH team on steve.partridge@consultcih.co.uk and Simon Smith at simon.smith@consultcih.co.uk who can assist in the following key aspects of your response:

- Generating initial modelling of the proposed settlement for your HRA business plan.
- Developing written briefings on the implications for your authority, assisting in identifying the key factors for your response.
- Running briefings and presentations for stakeholders.
- Developing a long term plan for your HRA business plan.

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