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# RAISING THE ROOF

## Analysis of Housing Revenue Account Headroom

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*Summary Report*



Together we serve the interest of more than a million homes in England

## Contents

<b>Executive Summary</b>	<b>1</b>
<b>1. Introduction and Background</b>	<b>7</b>
<b>2. Methodology</b>	<b>10</b>
<b>3. Analysis of trends in Borrowing Headroom</b>	<b>13</b>
<b>4. Learning from the Housing Association sector</b>	<b>22</b>
<b>5. Commentary on Findings</b>	<b>31</b>

## Executive Summary

### Headline Outcomes and Key Findings

This report is an analysis of the extent of, and trends in, unutilised borrowing headroom within local authority Housing Revenue Accounts in England. Our analysis suggests local authorities will invest, given policy clarity and the opportunities to do so but that they need to keep a buffer of borrowing headroom to be able to mitigate risks and plan ahead for long-term investment. This is what the Social Housing Regulator expects housing associations to do and this contributes to their financial viability rating accordingly.

The analyses set out in this report should not be seen as advocating the abolition of maximum ceilings on borrowing within the HRA. However, the funding approaches of both sectors suggests that the Government should consider the case for adopting a new approach to the setting of maximum borrowing limits within HRAs, placing them firmly within the Prudential Indicator framework within the Prudential Code. This would have the advantage of adapting a system that has already operated effectively for 13 years without excessive borrowing, whilst allowing local authorities to operate their HRA business plans in much closer alignment with the housing association sector.

1. The overwhelming majority of authorities (over 80%) are operating their business plan at or close to the Debt Cap (within 20%).
2. Only a very small number of authorities are what might be described as significantly "under-borrowed" compared to their Debt Cap.
3. The majority of headroom (60%) sits in authorities within 20% of their Debt Cap.
4. From 2015, there is some evidence of retrenchment around borrowing levels, principally driven by a step-up in Right to Buy sales since 2014, and policy uncertainty following the general election in 2015, particularly around the possibility of High Value Asset sales policy being implemented and the announcement of a four-year rent cut: *"Authorities would borrow to invest with more confidence but the financial and policy environment has been particularly uncertain since 2014.15"*.
5. When setting business plans, the interplay between revenue reserves and borrowing levels is significant as both offer buffers against future policy, financial and market uncertainty. Local authority landlords hold significantly less in revenue reserves than their housing association counterparts (limited to £1,600 per property within local authorities) and cannot therefore rely on their revenue reserves to act as such a buffer to the same degree as housing associations.
6. Comparing council housing business planning with housing association business planning illustrates that if the Social Housing Regulator were applying a viability rating to authorities within 20% of their maximum funding facility, there is a risk that the rating would be at V2 or below.
7. If housing associations were in the same situation as 80%+ of local authorities with regard to borrowing headroom, not only would there be unlikely to be investment until new facilities were negotiated, the Regulator might be critical of such investment.

8. Allowing authorities to present business plans with future increases in Debt Cap acknowledging the maintenance of headroom against future risk in the plans, would be the equivalent of the regulatory requirement on housing associations to maintain liquidity, and to negotiate increased capacity prior to embarking on a development programme.
9. The Government's approach to the treatment of HRA borrowing within the national accounts highlights a fundamental difference in approach between central and local government. The Government regards council housing as housing that continues to be subsidised with a *funding allocation*, whereas local authorities (and housing associations) seek agreement to view social housing as *investment*, as part of a sensible and long-term business plan which is paid back through rental income and is not paid for via general taxation.
10. The government should consider the case for adopting a new approach to the setting of HRA debt caps, placing them firmly within the Prudential Indicator framework within the Prudential Code allowing local authorities to operate their HRA business plans in much closer alignment to those within the housing association sector.

### Executive Summary

This report is an analysis of the extent of, and trends in, unutilised borrowing headroom within Housing Revenue Accounts in England. It incorporates an analysis and comparison of the debt and headroom position for all local authorities with stock at 2015, 2016 and beyond. It also identifies the principal constraints on local authority behaviours towards using their headroom for investment and provides a comparison of the headroom position with the behaviours of the housing association sector, particularly in the context of the requirements of the Social Housing Regulator.

This analysis makes a case for the extension of borrowing limits for Housing Revenue Accounts in England. This is principally on the basis that individual authorities within their business plans are able to set their own borrowing and financing limits within the context of the long term viability of the plan, in line with best business practice and the operation of the Local Government Prudential Code.

Such an approach would allow investment to take place over a sensible long-term planning period which would mirror the operation of business planning in the Housing Association sector, where authorities are able to extend their borrowing limits prior to embarking on investment programmes.

### Analysis of Debt and Headroom trends

1. The net change in debt levels and amount of borrowing headroom up to March 2015 was insignificant and very likely solely due to local decisions around future business planning. There would not appear to be any clear and indefinable trends in behaviours towards actively borrowing or actively repaying (certainly not in net terms) to that point.
2. Overall, whilst HRA headroom has increased since 2013, this is partially in line with stock loss from the Right to Buy and other disposals.

3. This is a relevant benchmark-position given the 2015 general election and subsequent announcement of proposed government policies which might affect the attitudes and appetites of authorities towards borrowing and repayment.
4. The overwhelming majority of authorities (89%) were operating their business plan at or close to the Debt Cap (within 20%) in 2015. This is a relevant factor given the comparison with the housing association sector.
5. Only a very small minority of authorities (less than 10%) are what we might describe as significantly "under-borrowed" compared to their Debt Cap, though it is acknowledged there will be local reasons for this at each authority. However, over one quarter of all headroom was in these authorities, highlighting that a change in behaviour of a small minority could have a significant impact on national totals.
6. The overwhelming majority of authorities (131 out of 158, or 83%) were continuing to operate their business plan at or close to the Debt Cap (within 20%) by 2016. The very small minority of authorities described as "under-borrowed" compared to their Debt Cap actually reduced within the 2015.16 year, though the amount of headroom remaining amongst these authorities remains around 25%.
7. From 2015, there is some limited evidence of retrenchment around borrowing levels, principally driven by a step-up in Right to Buy sales since 2014, and policy uncertainty following the general election in 2015, particularly around the possibility of the High Value Asset Sales policy being implemented and the announcement of a four-year rent cut. The reduction in borrowing levels is not therefore significant in this context.
8. The single biggest reason quoted as to why authorities might not invest via borrowing into new council housing is linked to the Right to Buy, specifically the level of discounts and the operation of the rules for the recycling of receipts.
9. The majority of headroom, 60% - or the equivalent of 15,000 new homes on a £ for £ borrow-to-invest basis - sits in authorities within 20% of their debt cap.
10. Only a small number of authorities have very large un-invested borrowing capacity - there is actually some evidence that some of this is being released.
11. The overwhelming majority of authorities are managing their borrowing in the context of their business planning. There are with marginal increases or reductions representing the ebb and flow of day-to-day financial management in the HRA, as opposed to actively borrowing or actively repaying debt.
12. The evidence suggests that only a small number (perhaps no more than a handful) are actively repaying debt as a policy objective.

13. The principal concern for authorities is that they are able to engage in a business planning process where an appropriate view can be taken on the balance between risk, revenues and policy uncertainty. The central conclusion is that, as far as possible, the removal of policy uncertainty would allow authorities to borrow for investment with more confidence.
14. The principal narrative arising from the analysis of trends in borrowing and headroom levels is one rooted in: *"Authorities would borrow to invest with more confidence but the financial and policy environment has been particularly uncertain since 2014.15."*

### Learning the lessons from housing associations

15. Local authorities cannot rely on their revenue reserves to act as a buffer against future business plan uncertainties to the same degree as housing associations. Therefore, many regard headroom within the Debt Cap as a form of buffer against future uncertainty.
16. All housing associations negotiate a maximum funding facility with their funders. Housing associations would not be expected to borrow up to their funding limit given the need for their business plans to hold buffers against risks within the plans.
17. The greater the business risks associated with a business plan, the more of a buffer against unforeseen changes in circumstances is required.
18. Utilising an assessment of the equivalence for housing association viability ratings through a proxy of %age borrowing compared to prevailing funding facilities, only around one third of HRA borrowing headroom sits in authorities that, all other factors being equal, would unequivocally achieve a V1 Rating.
19. The consensus view of HA finance directors is that they would seek to extend facilities when borrowing reaches 80% of the current maximum.
20. Around three-fifths of HRA headroom sits in authorities where borrowing is greater than 80% of maximum facility (for HRAs, this is the Debt Cap). If the Social Housing Regulator were applying a viability rating to these authorities, there is a risk that this would contribute to a rating that would be at best V2. Best practice within HA financial management suggests that, above this benchmark, associations would seek to extend their facilities.
21. One fifth of HRA headroom sits in authorities where borrowing is greater than 90% of the maximum facility (Debt Cap). Applying a viability rating might, all other factors being equal, even risk a V3 rating or lower, depending on the precise position.
22. Whilst the total amount of HRA headroom could, if utilised pound-for-pound on new development, deliver c22,500 new homes, the headroom to deliver c15,000 of these homes is within authorities that are within 20% of their debt cap. If this were the capacity position within

housing associations, the Regulator and funders might be critical of authorities borrowing to build those 15,000 homes without first extending their borrowing capacity.

The key lessons to learn from regulation of the housing association sector are therefore that:

23. Acting to reduce policy uncertainties would improve the equivalent viability rating for authorities in a regulatory context by reducing the amount required to be held as buffers against risk. Such uncertainties in an HRA context primarily relate to the Right to Buy, future policies towards asset sales, and rent policy.
24. Allowing authorities to present business plans with future increases in their Debt Cap allowing the maintenance of headroom against potential future risks in the plan, would be the equivalent of the regulatory requirement on housing associations to negotiate increased capacity with funders prior to embarking on a development programme.

### Appetite for Investment - the need for a change in mindset

25. All councils need new homes, of all types and tenures. We have yet to come across a local authority anywhere that does not want (or need) more social and affordable housing. Our analysis suggests local authorities will invest, given policy clarity and the opportunities to do so.
26. Whilst most of the headroom in HRAs is, for historical reasons, within 20% of the debt cap, this is significant in a self-financing environment given three principal policy uncertainties – memory of the old subsidy system is fading fast and mindsets are changing. If this headroom were in housing associations, not only would there not be investment until new facilities negotiated, the Regulator might be critical of such investment.
27. Authorities are also delivering on multiple fronts, incorporating HRA delivery and delivery via newly created local housing companies. Companies are a really key development in the debate around the operation of the Debt Cap in that where authorities see the opportunity to accompany investment in housing with the ability to earn a proportionate return and exercise sensible control over the business, they are investing.
28. The approach to the treatment of HRA borrowing within the national accounts highlights a fundamental difference in approach between central and local government. The Government regards council housing as housing that continues to be subsidised with a *funding allocation*, whereas local authorities (and housing associations) seek agreement to view social housing as *investment*, as part of a sensible and long-term business plan.
29. For such an agreement to be realised, the Government must be persuaded that borrowing behaviours are part of an overall long-term business planning mindset: when local authorities do not spend up to their Debt Cap, this is being prudent, building in risk buffers and protections,

essentially acting like a business, and increasingly these behaviours are becoming the norm the further on from 2012 that plans develop.

30. The analyses set out within this report should not be seen as advocating the abolition of maximum ceilings on borrowing within Housing Revenue Accounts. On the contrary, the comparison with the housing association sector highlights that all housing businesses are subject to maximum investment capacity constraints.
31. The operation of both sectors suggests that the Government should consider the case for adopting a new approach to the setting of maximum borrowing limits within HRAs placing them firmly within the Prudential Indicator framework within the Prudential Code. This would have the advantage of adapting a system that has already operated effectively for 13 years without excessive borrowing, whilst allowing local authorities to operate their HRA business plans in much closer alignment with the housing association sector

## 1. Introduction and Background

### Introduction

- 1.1 The Association of Retained Council Housing (ARCH), in partnership with the National Federation of ALMOs (NFA) commissioned Savills to undertake an analysis of the extent of, and trends in, unutilised borrowing headroom within Housing Revenue Accounts in England.
- 1.2 The work has been undertaken during the course of 2017 and, in draft form, has been the subject of a series of presentations to stakeholders since July. This report represents a summary of the outcomes of the analysis.
- 1.3 This analysis makes a case for the extension of borrowing limits for Housing Revenue Accounts in England, principally on the basis that individual authorities within their business plans are able to set their own borrowing and financing limits within the context of the long term viability of the plan, in line with best business practice and the operation of the Local Government Prudential Code. Such an approach would allow investment to take place over a sensible long-term planning period which would mirror the operation of business planning in the Housing Association sector.
- 1.4 This analysis covers the following principal areas:
  - An analysis and comparison of the debt and headroom position for all local authorities with stock at 2015 and 2016;
  - Identification of the principal constraints on local authority behaviours towards using their headroom for investment;
  - An analysis and comparison of the headroom position with the behaviours of the housing association sector, particularly in the context of the requirements of the Social Housing Regulator.
- 1.5 This latter point has been a key focus for this work. Housing associations provide essentially the same service to the same client groups from the same types of assets as local authorities, but funded by private finance. Constraints on their borrowing behaviour therefore operate both through public housing and housing finance policy, but primarily through the requirements of their funders and the Regulator.
- 1.6 It is felt that a comparison between sectors throws additional light on the Debt Cap/Headroom debate for local authorities, and begins to move the debate away from "*HRA borrowing as a public cost to be controlled*" and towards "*HRA borrowing as viable and fundable investment to achieve the delivery of new affordable housing*".

### Background

- 1.7 The Housing Revenue Account (HRA) self-financing settlement of March 2012 abolished the former HRA Subsidy System and replaced it with a new form of financing, based on the retention of rental surpluses by local authorities with council housing stock for reinvestment in services, maintenance of the housing stock, and the development of new council housing.
- 1.8 Borrowing for investment in capital expenditure within the HRA is accounted for within the public accounts as public expenditure, and the Government therefore seeks to control levels of borrowing within public expenditure limits. In the previous subsidy system, borrowing levels for council housing were controlled via the operation of two mechanisms: firstly through the definition of a maximum Capital Financing Requirement<sup>1</sup> within successive annual subsidy determinations, but secondly and more importantly, through the capturing of rental surpluses for local HRAs for payment into central government.
- 1.9 Exercise of control over borrowing in the newly self-financing system is operated via the determination of a "Maximum Limit on Indebtedness" (or Debt Cap) which is set annually for each authority with an HRA. This delivers an overall ceiling, and therefore constraint, on borrowing for investment.
- 1.10 When self-financing was implemented, due to the technical operation of the former subsidy system, individual authorities found themselves with borrowing levels either at the level of the Debt Cap or below<sup>2</sup>. The incidence of the availability of borrowing headroom beneath the Debt Cap was therefore a function of historical decisions taken by authorities under a different financial system.
- 1.11 Given the increasing shortage of social and affordable housing and the natural focus of authorities on wanting to increase the supply of new housing, the Debt Cap is seen as a principal constraint on new development.
- 1.12 Since 2012, there has been much debate and advocacy around making a case for the relaxation or outright abolition of Debt Caps. At the same time, most authorities operate their business plans with borrowing below the Debt Cap. Whilst, as set out above, the level of starting headroom below Debt Cap was principally a function of historical decisions taken in a different era, it is appropriate to acknowledge that as the self-financing system proceeds, authorities could be expected to take different and more long-term, business-like, approaches towards their business planning. This throws into sharp focus the behaviours of authorities towards financing investment from borrowing and the use of borrowing headroom up to the Debt Cap.

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<sup>1</sup> *Capital Financing Requirement = the measure of net indebtedness for local authorities (see para 2.9)*

<sup>2</sup> *Headroom commenced as the difference between the actual Capital Financing Requirement and the former Subsidy Capital Financing Requirement at March 2012*

- 1.13 The overall Debt Cap for all authorities with HRAs is £29.3billion. Published figures<sup>3</sup> from Communities and Local Government (CLG) highlight that, in aggregate, authorities have borrowing levels at more than £3billion below this level.
- 1.14 Following the initial impetus of self-financing, with research<sup>4</sup> carried out at the time suggesting that authorities had plans to deliver upwards of 20,000 new council homes over the next 5-10 years, headroom has grown steadily since 2014, with a further increase since 2015.
- 1.15 The previous Coalition Government offered a limited programme for "bidding" to raise Debt Caps in 2014. This programme was under-subscribed.
- 1.16 In order to enhance the case to government for relaxation or abolition of the Debt Cap, ARCH, and the NFA have therefore sought to further analyse and understand the behaviours of local authorities so that the any barriers to investment in new homes can be understood and addressed.
- 1.17 This work has been carried out specifically in the context of understanding behaviours in relation to the Debt Cap. Other work is ongoing, including working with Government and a number of local authorities towards how bespoke deals might be structured; this may affect the Debt Cap in each of those individual cases.
- 1.18 Analysis work on the scope and extent of new housing companies was commissioned at the same time as this analysis. The work on housing companies has since been integrated with other research pieces being undertaken on the subject.

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<sup>3</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/654873/2015-16\\_Capital\\_expenditure\\_and\\_financing\\_for\\_HRA.xlsx](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/654873/2015-16_Capital_expenditure_and_financing_for_HRA.xlsx)

<sup>4</sup> *Chartered Institute of Housing/ARCH November 2012*

### 2. Methodology

#### Overall approach

- 2.1 The analysis is based on Debt Cap and borrowing information between 2013 and 2016 as set out in the CIPFA Housing Revenue Account statistics, with research-based consultative information giving evidence of behaviour into 2017. The statistics collate all housing revenue income and expenditure information together with borrowing levels for all local authorities in England. This allows the analysis to be placed in the context of the full picture for local government, including for those authorities with specific characteristics that might otherwise distort the analysis (for example those with very limited stock holdings following the majority transfer of most of their housing stock).
- 2.2 The statistics for 2016.17 will not become available until early 2018. In order to offer some dimension to the analysis around behaviour into 2017, a number of specific follow-up discussions were held with authorities, principally to test whether there was likely to be any evidence of much-changed behaviour in 2016.17.
- 2.3 The comparison with Housing Association (HA) sector behaviours was undertaken through a review of the relevant Global Accounts analyses published by the Homes and Communities Agency and discussions with the Treasury Management team (which offers funding services to the HA sector) within Savills and consultancy colleagues engaged in providing capacity studies within the HA sector. Savills published a research analysis<sup>5</sup> of the extent of unused financial capacity within small to medium sized housing associations in late 2016 which also provided a solid background of data to support the analysis within this report.

#### Technical notes

- 2.4 As referenced above, the number of authorities with housing stock in England has varied over time as a result of the transfer of stock to housing associations. In generating this analysis, there are a number of technical adjustments which need to be provided for in order to ensure that the analysis represents a fair and reasonable picture of behaviours and trends across the sector.
- 2.5 Examples of the types of authorities which are included within the national totals but which do not form part of the analysis for this report are:
- Some authorities were in receipt of a self-financing settlement (hence Debt Cap) in 2012 but have subsequently transferred their housing stock.
  - Two authorities retain an HRA but this is solely focused on Private Finance Initiative (PFI) schemes following the transfer of the remainder of their stock - the treatment of financing requirements under PFI tends to distort the overall analysis as specific arrangements are in place for those authorities with HRA PFI schemes.

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<sup>5</sup> [http://www.savills.co.uk/research\\_articles/141280/210014-0](http://www.savills.co.uk/research_articles/141280/210014-0)

- Five authorities have large PFI schemes within a larger retained housing stock - as above, the treatment of PFI financing tends to distort the analysis and, as at 2016, each of these authorities show as technically "over Debt Cap".

2.6 The table below therefore sets out the basis for the analysis within this report.

*Table 1 - analysis of numbers of authorities*

Description	Number	Comment
No. of authorities with some housing stock between 2014-2016	174	This includes authorities which have reintroduced council housing since 2012 and which did not have a self-financing settlement
No. of authorities excluded from the analysis	7	For example Rochdale, Bradford - new housing subsequently disposed of Transfer authorities: Durham, Gloucester
No. of authorities in the 2012 settlement still with an HRA	165	
No. of authorities with PFI schemes only	2	Oldham, Salford
No. of authorities with large PFI schemes within wider stock	5	Manchester, Kirklees, Leeds, North Tyneside, Ashford
Hence - no. of authorities within this analysis	158	

2.7 Where we have included totals for all authorities, or a different number than the 158 cohort forming the basis of the headroom analysis, this is identified throughout.

2.8 In comparing borrowing levels to Debt Caps, the following sources are utilised:

- Debt Caps - as set in the "Limit on Indebtedness" Determination published by Communities and Local Government (CLG)
- Borrowing levels - the closing HRA Capital Financing Requirement (HRACFR).

2.9 The HRACFR is a technical measure of the underlying amount that an authority would require to borrow in order to finance its HRA Capital Programme, after taking into account all other sources of capital finance available. It is not necessarily the actual amount of loans outstanding. All authorities publish an overall annual Treasury Management Strategy which sets out the extent to which actual loans will be drawn across the whole authority. For the purposes of this analysis, the level of HRA borrowing is defined as the HRACFR, whether this has been funded by actual loans taken from external sources or funds internally borrowed from a council's General Fund.

### Other sources

- 2.10 During the course of this work, cross-reference to published data from CLG was undertaken to ensure consistency. It is noted that the published statistics<sup>6</sup> by CLG for borrowing levels at 2016, when initially published, appeared to indicate that borrowing headroom was £4.45billion.
- 2.11 Further investigation highlighted that there were anomalies within this published data, in particular where borrowing levels had not apparently been picked up correctly from source data. This may arise from inaccurate returns from individual authorities.
- 2.12 Uncorrected, this suggested that there was a large increase in headroom during 2015.16. This was not the case as there were technical changes, movements in the number of authorities and inaccurate data sourcing which are not reflective of actual behaviours. This anomaly was reported to CLG officials, particularly as in its original form, this formed the basis of headlines within the housing trade press. It would appear that the anomalies have now been resolved.
- 2.13 Investable headroom identified for the relevant cohort of authorities was actually £3.35billion at April 2016 (an increase from £3.16billion in 2015).

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<sup>6</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/654873/2015-16\\_Capital\\_expenditure\\_and\\_financing\\_for\\_HRA.xlsx](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/654873/2015-16_Capital_expenditure_and_financing_for_HRA.xlsx)

### 3. Analysis of trends in Borrowing Headroom

3.1 The analysis below summarises the following:

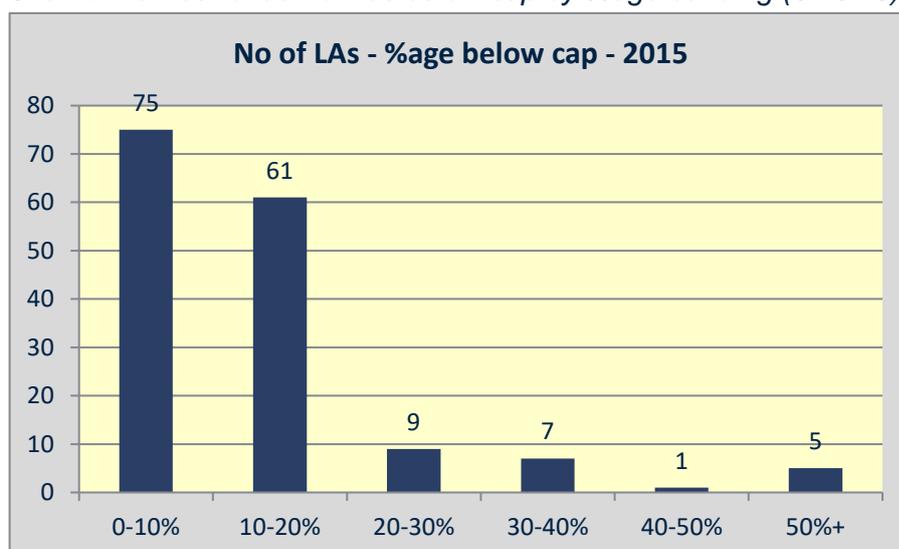
- A comparison of borrowing levels against Debt Caps at 31.3.15 - this establishes a baseline against which to measure changes in behaviour since April 2014.
- A comparison of the movements in headroom between 2015 and 2016.
- An analysis of all authorities classified into whether they are "borrowing", "repaying" or "maintaining" borrowing levels.
- An interpretation of the reasons for the behaviours set out.

#### Headroom position at 2015

3.2 A key focus for this analysis is the extent to which authorities are operating below their Debt Cap (%age below) rather than the cash amount. This methodology has been adopted so that a meaningful comparison to behaviours within the HA sector can be made in the next section. The extent to which authorities are below cap is banded in 10% bandings. This allows an identification of those authorities with borrowing levels very close, relatively close, or a large distance from their Debt Cap.

3.3 The chart below sets out the headroom / debt cap position at 31.3.15 for the 158 authorities in the cohort.

*Chart 2: number of authorities below cap by %age banding (31.3.15)*



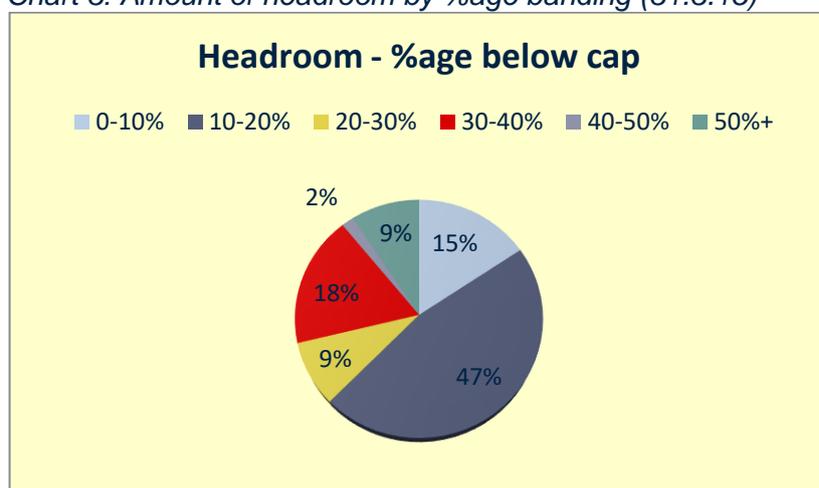
The chart shows that:

- Nearly half (75 out of 158) of all authorities were within 10% of their Debt Cap
- Nearly 90% (139 out of 158) of authorities were within 20% of their Debt Cap
- Only a small minority of authorities were well below their Debt Cap - just 13 out of 158 with greater than 30% headroom.

3.4 The total headroom below Debt Cap on 31.3.15 was £3.162billion. This represented an increase on 31.3.14 of £29million.

3.5 The chart below sets out the same headroom / debt cap position at 31.3.15 in borrowing terms.

*Chart 3: Amount of headroom by %age banding (31.3.15)*



The chart shows that:

- 62% of headroom (£1.96billion) was in authorities within 20% of their Debt Cap - of which £0.5billion was in authorities within 10% of their cap.
- Whilst only a very small number of authorities are under-borrowed (for example with borrowing below 30% of the cap - 13 in number), the amount is not insignificant - 28% of the total national total (£0.89billion).
- Action to release capacity in those authorities which are under-borrowed, for which there may be appropriate locally-based reasons in each case, would therefore see a significant overall change in the level of headroom outstanding.

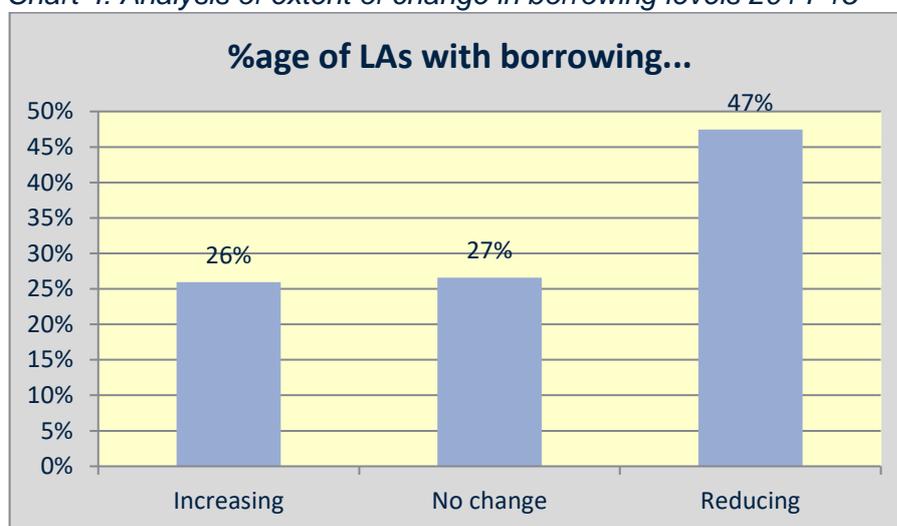
### Trends in the headroom position at 2015

3.6 The chart below sets out a straightforward interpretation of whether debt levels increased or reduced during 2014.15.

The chart shows that:

- Within the overall net reduction in borrowing versus Debt Cap of £29million, around one quarter of authorities increased borrowing, one quarter stayed the same (within small tolerance) and around half reduced borrowing levels.
- The net changes in borrowing levels overall was around 1% of the Debt Cap - this represents around the level of reduction in stock numbers arising from movements such as Right to Buy sales and other disposals during the year (1,502k units in 2015 compared to 1,515k units in 2014).

Chart 4: Analysis of extent of change in borrowing levels 2014-15



### 3.7 The foregoing position statement as at 2015 suggests the following high level conclusions:

The net change in debt levels and amount of borrowing headroom up to March 2015 was insignificant and very likely down solely to local decisions around future business planning; there would not appear to be any clear and definable trends in behaviours towards actively borrowing or actively repaying (certainly not in net terms) to that point.

This is a relevant benchmark-position given the 2015 general election and subsequent announcement of proposed government policies which might affect the attitudes and appetites of authorities towards borrowing and repayment.

The overwhelming majority of authorities (89%) were operating their business plan at or close to the Debt Cap (within 20%). This is a relevant factor given the comparison with the HA sector.

Only a very small minority of authorities are what we might described as "under-borrowed" compared to their Debt Cap, though it is acknowledged there will be reasons for this at each authority. However, over one quarter of all headroom was in these authorities, highlighting that a change in behaviour of a small minority could have a significant impact on national totals.

## Raising the Roof: Analysis of Housing Revenue Account Headroom

3.8 This position statement is next compared to behaviour during the 2015.16 financial year.

### Analysing headroom between 2015 and 2016

3.9 As at 31.3.16, headroom in the relevant cohort of authorities was £3.346billion. This is an increase in headroom of £184million. *Prime facie*, there is therefore some evidence of retrenchment in levels of net borrowing across all authorities during the 2015.16 financial year. A further review of whether this is a reasonable conclusion from the statistical evidence is set out below.

3.10 The movement in the number of authorities in the various bandings below Debt Cap, and associated headroom, between 2015 and 2016 is set out in the table below.

*Table 5: Analysis of movement in headroom by authority numbers and amount 2015-16*

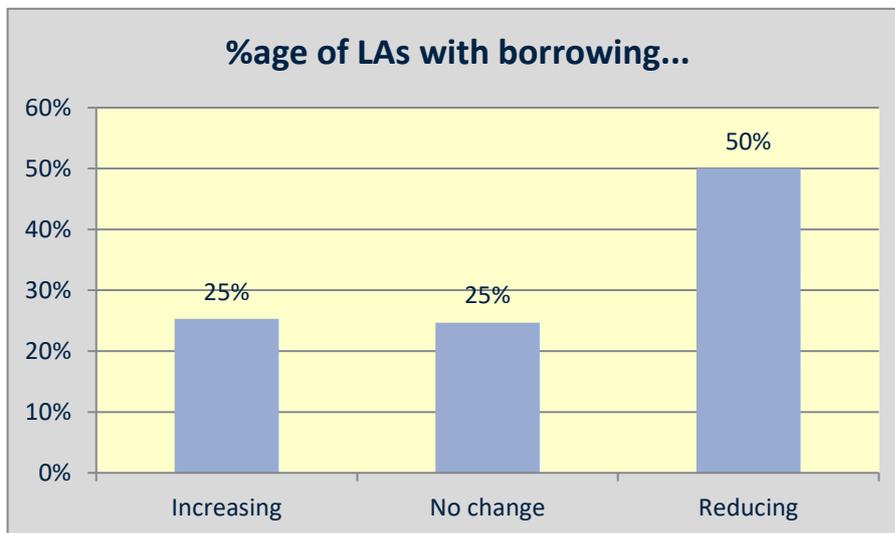
<b>Below cap</b>	<b>0-10%</b>	<b>10-20%</b>	<b>20-30%</b>	<b>30-40%</b>	<b>40-50%</b>	<b>50%+</b>	<b>Total</b>
No of LAs 2016	73	58	16	5	2	4	
No of LAs 2015	75	61	9	7	1	5	
<b>Change</b>	<b>-2</b>	<b>-3</b>	<b>+7</b>	<b>-2</b>	<b>+1</b>	<b>-1</b>	
Headroom 2016	595	1,352	552	523	67	257	<b>3,346</b>
Headroom 2015	495	1,479	278	565	53	293	<b>3,162</b>
<b>Change (+ - increase in headroom)</b>	<b>+100</b>	<b>-127</b>	<b>+274</b>	<b>-42</b>	<b>+14</b>	<b>-35</b>	<b>+184</b>

The table highlights that:

- Overall headroom rose by c6% during 2015.16 compared to stock reductions of 0.75% (1,491k at 31.3.16 cf 1,502k at 31.3.15).
- Headroom moved within the group of authorities within 20% of their debt cap, with a small net number with slightly reduced headroom across this banding.
- However, the movement could not be said to be significant (£27million net change in borrowing headroom amongst this group).
- The largest increase (change) in headroom is shown in those authorities with borrowing levels within 30% of their debt cap but with headroom above 20%. This suggests that, where authorities were holding a form of buffer against future business plan challenges, there may be some evidence that this buffer was increased during this financial year.
- Conversely, for those authorities under-borrowed (borrowing at least 30% below their cap), there was an overall net reduction in headroom during this year, perhaps suggesting that plans to invest decided upon before 2015, were being implemented during 2016 in the knowledge that there was adequate headroom remaining.

3.11 The chart below sets out a straightforward interpretation of whether debt levels increased or reduced during 2015.16. As for 2014.15, the chart reflects around one quarter of authorities increasing borrowing, one quarter with the same borrowing level and around one half reducing borrowing.

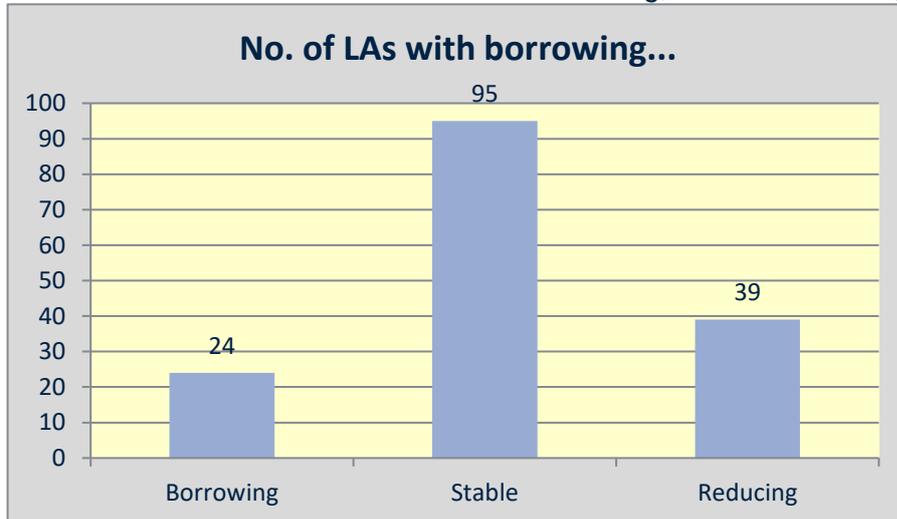
Chart 6: Analysis of extent of change in borrowing levels 2015-16



### Classifying debt behaviours between 2015 and 2016

- 3.12 Charts 4 and 6 represent a straightforward capture of the movement in debt and headroom between 2014 and 2016. In practice, the ebb and flow of treasury management and capital financing decisions, coupled with the commitment of resources from Right to Buy receipts to debt repayment as required within the One for One Agreement regulations, mean that there are very often small movements in debt levels annually, and that these are not necessarily reflective of an active strategy to invest, nor an active strategy to repay.
- 3.13 Our analysis has therefore sought to classify authorities towards their behaviours in one of three ways, based on our analysis and interpretation of the movement in debt levels between 2014 and 2016, and beyond. This was cross-referenced with information available about local authorities within the public domain (from published accounts) and from our knowledge of individual authorities within the sector.
- 3.14 The classification is as follows:
- The authority is actively *borrowing* - debt levels have consistently increased across the period, which could be for a number of reasons associated with investment into new homes or the existing housing stock
  - The authority is *repaying* debt - debt levels have consistently and significantly reduced across the period and there is evidence of a trend, though not of a trend to eliminate debt
  - The authority has a *stable* debt position - either debt levels have not changed, or debt has marginally increased/reduced in either year, or has increased in one year, reduced in the other, or there is otherwise no clear evidence of a trend in debt levels.
- 3.15 The chart below sets out a summary of the total number of authorities analysed according to this classification.

Chart 7: Classification of authorities into borrowing, stable or reducing debt



3.16 Our assessment of these behaviours, based purely on the statistical evidence, is that:

- 60% of authorities (95) exhibited no clear pattern towards borrowing for investment or repaying debt during this period.
- Around 15% appeared to be actively investing via increasing borrowing - it should be noted that authorities are able to invest utilising a large range of other capital resources including receipts, via depreciation and revenue, and that therefore we would expect that many more authorities are investing in their stock and new homes without the need to draw on borrowing.
- Around a quarter appear to be reducing debt levels year on year within the business plan, though this does not necessarily represent evidence of active repayment.

For this latter group, this should certainly not be interpreted as a commitment to the active clearance of debt (though we are aware of a handful of authorities that have publically set themselves the goal to clear debt), rather that revenue resources are being utilised to reduce borrowing levels, holding headroom within the Debt Cap rather than holding revenue in reserves.

There are very good reasons why it could make sense for surplus HRA revenue resources to be committed to reducing borrowing levels given the wider pressures on local government finances.

3.17 Depending on the interpretation of the figures from the above chart, it could be said that 75% of authorities are either actively borrowing or holding their debt levels stable pending consideration of further investment. Alternatively, 85% of authorities are not actively borrowing at this time. In seeking to understand the backdrop to the decisions being taken within business plans locally, we have set out below some possible reasons which underpin these behaviours.

### Interpreting the reasons for different behaviours

- 3.18 As noted above, there is some limited evidence of a net retrenchment of borrowing positions within the 2015.16 financial year. During the course of this analysis, we have contacted a number of authorities with a view to understanding in more detail the rationale for local behaviours.
- 3.19 Local authority housing operates very much in the context of the housing and local government financial policy environment. We would expect that major announcements on future policy direction would have a significant impact on local decision making within business plans. Business plans are long term documents, setting out the capability of the HRA asset base to generate income to cover likely costs over a 30 year period. Whilst most (if not all) authorities are very keen to add new council housing to their stock, decisions on the basis for such investment need to take account of the policy environment.
- 3.20 Between 2015 and 2016 (and to date), the following three trends have been identified as likely to impact on local decision making within business plans, some to a greater extent than others:
1. The extension of Right to Buy discounts in April 2012 (at the point of self-financing) did not lead initially to a large take-up by tenants (with the exception of a small number of authorities); however by 2014, and into 2016 and beyond, trends towards increasing Right to Buy sales have increased. The incidence of increased Right to Buy sales, coupled with constraints on the recycling of receipts, and the potential for newly developed council housing to be subject to the Right to Buy in the future are likely to inhibit investment in new housing. The key factor is the combination of *enforced sale* of an asset with the *inability to recycle 100%* of the proceeds of the sale.
  2. The announcement of a 1% cut in rents annually from 2016 to 2020 reduces the ability within a business plan to finance new development over the long term. The policy will result in the reduction in real terms annual rent income of around £1billion in 2020 compared to the position in 2016. The impact of this policy on housing association investment in new development has also been noted by the National Housing Federation. Whilst the impact £ for £ on HRA new build programmes is unlikely to be great in the short term, the primary factor is to deliver uncertainty and unpredictability to future business planning.
  3. The announcement of a proposed policy towards the Sale of High Value Assets was also made after the 2015 general election. This proposed policy would mean each HRA having to pay a levy calculated on the basis of an assumed level of sales of higher value assets when they became void. This policy announcement has undoubtedly caused some authorities to reconsider their plans in the short to medium term given the considerable uncertainty around the possible timing and level of future levy payments.
- 3.21 Taken together, these impacts provide for significant uncertainty and unpredictability around the future level of income that can be projected within business plans. The extent to which these have affected behaviour towards HRA borrowing has been tested qualitatively and set out below. It is

noted that one, large-scale, response to these and other pressures (including the constraint of the Debt Cap itself) has been the establishment of new local housing companies to offer an alternative delivery mechanism.

- 3.22 The *primary* reason why an authority might reconsider pursuing a policy towards actively borrowing, or not adopt such a strategy in the business plan in the first place, is due to the operation of the Right to Buy. For some, it is the actual availability of the Right to Buy that is the issue. For most, however, the primary factor is the sales price and the lack of ease with which the receipt can be retained locally and recycled towards new development. 50% of authorities contacted suggested that this was the primary reason for not borrowing more actively to invest in the HRA.
- 3.23 The second largest group of contacts suggested that uncertainty over the future of the High Value Asset Sales policy was the primary concern. Whilst this policy may not in itself lead to a disincentive to develop new homes, the uncertainty is focused over the scale of the levy, and whether in time this might mean the viability of the entire HRA is brought into question. Around 30% of contacts cited this as the primary reason for not investing in new homes through borrowing at this time.
- 3.24 The rent cut announcement was cited as the primary reason for reconsidering investment via borrowing by around 20% of contacts. This may reflect a view taken by authorities relatively close to their Debt Cap where incremental reductions to revenue available in the business plan would mean that borrowing levels became increasingly difficult to service.

### Summary

- 3.25 In summary, there may be evidence that policy unpredictability following the 2015 general election has led to a limited net retrenchment of some authorities towards their borrowing levels. The key conclusions are:

Whilst there is some evidence of net retrenchment of the borrowing position between 2015 and 2016, the picture is mixed, and only a small number of authorities appear to have changed their behaviours very significantly.

Therefore, the overwhelming majority of authorities (131 out of 158, or 83%) were continuing to operate their business plan at or close to the Debt Cap (within 20%). The very small minority of authorities described as "under-borrowed" compared to their Debt Cap actually reduced within the 2015.16 year, though the amount of headroom remaining amongst these authorities remains around 25% (of the national total).

The single biggest reason quoted as to why authorities might not invest via borrowing into new council housing is linked to the Right to Buy, specifically the level of discounts and the operation of the rules for the recycling of receipts.

Policy announcements towards rent reductions and High Value Asset Sales have also affected the confidence of many authorities to invest in new housing.

The principal concern for authorities is that they are able to engage in a business planning process where an appropriate view can be taken on the balance between risk, revenues and policy uncertainty. The central conclusion is that, as far as possible, the removal of policy uncertainty would allow authorities to borrow for investment with more confidence.

### 4. Learning from the Housing Association sector

#### Introduction

- 4.1 A comparison has been undertaken between income, expenditure and debt levels within the local authority (HRA) sector and the housing association (HA) sector<sup>7</sup>.
- 4.2 This provides a backdrop to an extension of the analysis thereafter to cover the expectations of behaviours of housing associations were prevailing levels of HRA borrowing and headroom to apply in that sector.
- 4.3 The basis for this analysis, is to pose the question... *"If the current level of borrowing and the level of Debt Cap applied in the HA sector, what would be the expectations on housing associations from their funders and the Social Housing Regulator?"*
- 4.4 This is then utilised to demonstrate that, far from borrowing for investment being an issue primarily associated with "spending up to a borrowing limit", housing associations would be expected, by funders and the Regulator, to agree a longer-term view around their capacity for investment prior to actually investing, with the degree of headroom below maximum capacity linked to the views of uncertainties and risks around future market activity, and Government fiscal and housing policies.
- 4.5 Far from the view that holding headroom is something with which to be critical of authorities, given the level of uncertainties that prevail within the sector, there is strong evidence of rational behaviour by authorities in taking a sensible and proportionate long term view of their business plans.

#### The "national HRA" against HA Global Accounts

- 4.6 The chart below compares average debt levels between the HRA sector and the HA sector at 31.3.16.

The chart shows that:

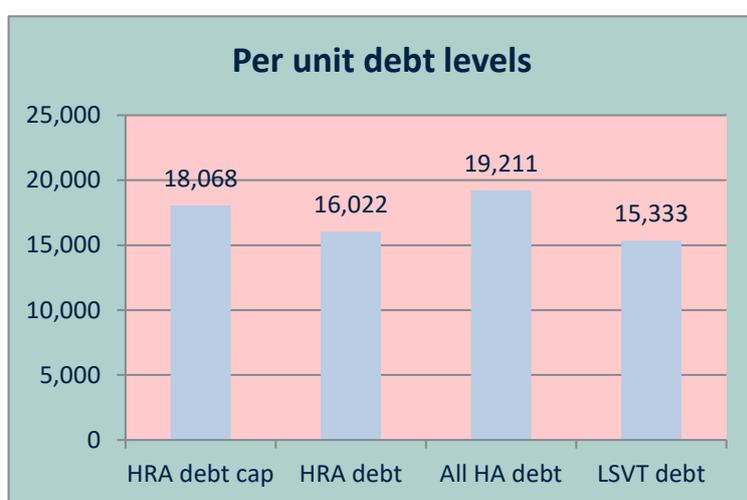
- Housing association debt is greater than the aggregate level of the HRA Debt Cap (per unit) - (£19.2k vs £18.1k). The HA debt level includes borrowing for investment in non-social housing tenures (such as market housing for rent or sale) and whilst this is not quoted separately within the Global Accounts, and many housing associations are actively diversifying their portfolios, the overwhelming majority of this debt will have been focused on social housing.
- Actual levels of HRA borrowing are however below actual HA debt levels by c£3k/unit, effectively represented by unused headroom within the Debt Cap and the Debt Cap being set at a level lower than prevailing HA debt.

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<sup>7</sup> A summary of the overall comparison between the national accounts for the two sectors has been drafted and will be made available following publication of this report

- Debt levels within Large Scale Voluntary Transfer (LSVT) Housing Associations are however *lower* than for the HRA. There are significant historical reason affecting this - many LSVT HAs began with little or no debt post-transfer; HRA Debt Caps were set on the basis of forward forecast of cashflows identified at 2012 and have not been significantly updated since and HRA Debt levels were determined through the 2102 settlement.
- Nevertheless, it is likely that there is capacity within LSVT HAs to increase borrowing just as there is within HRAs given a view on maximum borrowing capacity.

Chart 8: Debt levels between local authorities and housing associations 31.3.16



- 4.7 Further to this comparison, the total amount of revenue held in reserves within HRAs nationally was £2.607billion at 31.3.16, or £1,613 per property. The equivalent amount within the Global Accounts<sup>8</sup> was over £7,000 per property.
- 4.8 Housing associations therefore hold significantly more in reserve against future uncertainties within their business plans - for example to address reductions in income or occupancy, address the risks of cost pressures, or most likely to provide a buffer against an increase in the cost of borrowing.
- 4.9 The corollary to this is that local authorities hold a relatively low level of reserves within their HRAs, though this did increase from 2015 to 2016 (by about £130/property). When setting business plans, the interplay between revenue reserves and borrowing levels is significant. Both offer buffers against future policy, financial and market uncertainty.
- 4.10 The central conclusion from this comparison is that local authorities cannot rely on their revenue reserves to act as a buffer against future business plan uncertainties to the same degree as housing associations. Therefore, there is the likelihood that many regard headroom within the Debt Cap as a form of buffer against future uncertainty.

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<sup>8</sup> Accumulated reserves; note that the full amount of these reserves might not be immediately available to be drawn

### Financial Viability and Capacity

- 4.11 We have taken evidence from colleagues within the HA sector and from those who provide treasury and capacity-related services to the HA sector around the likely behaviours that HAs adopt given the pattern of borrowing and headroom within HRA authorities. This is based on an estimated view of *financial viability* as applied to the HA sector by the Homes and Communities Agency (Social Housing Regulator) in assessing compliance with the Governance and Viability Standard for Registered Providers<sup>9</sup>.
- 4.12 The Regulator makes an assessment of the financial viability of each association annually. The Viability Rating is provided alongside an assessment of the effectiveness of the governance arrangements within each association. The Viability Rating is used by funders and other stakeholders to make judgements around the exposure that each association has to business risks given the current financial position.
- 4.13 The assessment against the Standard is based on there being an appropriate, robust and prudent business planning, risk and control framework in place which covers: access to sufficient liquidity at all times; financial forecasts based on reasonable assumptions; effective systems in place to monitor and report delivery; the financial and other implications of risks to the delivery of plans are considered; monitoring, reporting on and compliance with their funders' covenants.
- 4.14 The Rating is analysed into four possible outcomes - from V1 to V4. At the time of writing, there is one association classified as V3, 38 are rated V2 and 196 are rated V1.
- 4.15 The process for determining the Viability Rating is complex and multi-dimensional but is always focused on the capability of the association to sustain adverse policy, market and financial changes in its business plan, whilst continuing to meet its liabilities to its funders. Key factors which are reviewed as part of the process include:

Gearing and Interest Cover Ratios - these two key ratios are indicative of the extent to which an association has borrowing compared to both the value of its assets and the cost of that borrowing compared to the income that those assets produce. A low gearing ratio represents the ability for the association to go out and secure more debt based on the valuation of its asset base. Conversely, a highly geared association would not have as much capability to quickly be able to turn to additional borrowing to, for example, fund unexpected increases in committed capital expenditure. High interest cover suggests an association that has adequate revenue headroom to meet its debt costs.

Liquidity - as measured by the level of reserves and other sources of funds available to meet either unforeseen expenditure commitments and/or unexpected reductions in income, principally

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[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/419368/Governance\\_and\\_Financial\\_Viability\\_Standard\\_2015.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/419368/Governance_and_Financial_Viability_Standard_2015.pdf)

measured by reference to the availability of revenue to meet 18 months' worth of funding-cost commitments.

*Borrowing Capacity and the Business Plan* - the extent to which the business plan relies on future drawdown of borrowings to meet the commitments within the plan, compared to the current maximum debt-capacity position in place with funders. There is a distinction to be made between maximum capacity and the current facilities which are in place with funders. An association may have a low gearing ratio but only have negotiated facilities with funders up to that low level. Such a position would constrain an association's response to risks in the business plan.

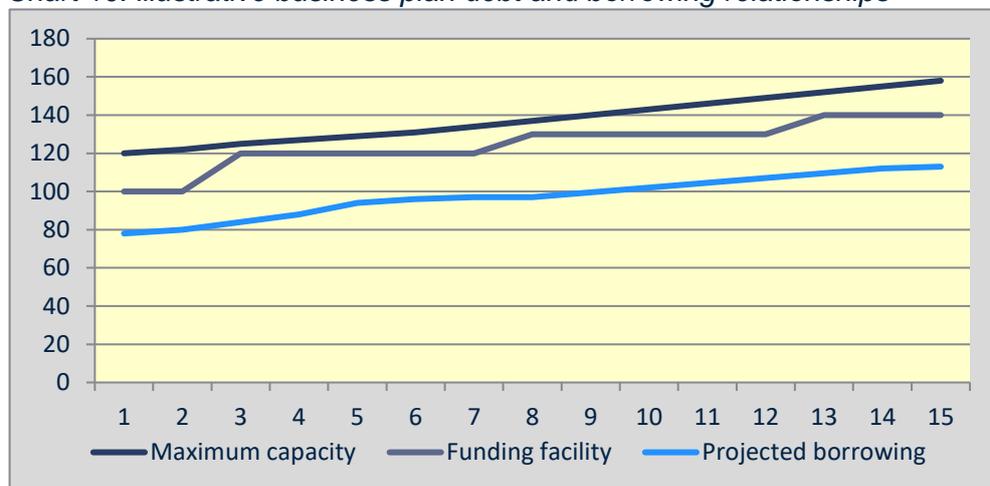
- 4.16 These factors form part of the analysis and the interplay between all of them (and others) add up to the Viability Rating. Generally speaking (though not exclusively), the following are the key points to note:
- The higher the Gearing Ratio, the less likely an association is to achieve a higher Viability Rating.
  - The lower the Interest Cover, the less likely an association is to achieve a higher Viability Rating.
  - The lower the amount of reserves providing liquidity to cover liabilities, the less likely the association is to achieve a higher Viability Rating
  - The closer to existing its current maximum borrowing facility that an association is, the less likely an association is to achieve a higher Viability Rating.
- 4.17 Every association will have a prevailing *Maximum Funding Facility* negotiated with its funders. This may be related to asset values and interest cover ratios. However, in practice, once a facility is negotiated, it is in place until it is completed, refinanced or renegotiated. As an association borrows to invest and approaches maximum capacity, the expectation would be from funders and from the Regulator that early action would be taken to open discussions with funders around extending facilities (within gearing and interest cover constraints).
- 4.18 Put simply, an association would not expect to be able to have borrowed up to the maximum facility it has in place before it went back to funders to increase the facilities, and if it did, we would expect it to be criticised by the Regulator for doing so.
- 4.19 The consensus view amongst HA finance directors engaged was that they would seek to extend facilities when borrowing reaches 80% of the current maximum.
- 4.20 As an estimate of the impact on borrowing up to capacity, we have applied a generalised measure of financial viability on the basis that, all other measures being sound and within expected norms, the closer to maximum funding facility an association is, the lower its viability rating would be.
- 4.21 We have applied, as far as we consider reasonable given the differentials between the HRA and HA sectors, some principles from the regulatory framework for HAs to the borrowing and headroom for HRAs.

Figure 9: generic equivalence of potential viability rating

Classification	Borrowing compared to Facility/Capacity	Equivalent V Rating
GREEN	< 75%	V1
YELLOW	> 75%	V1/V2
AMBER	> 80%	V2/V3
RED	> 90%	V3/V4

- 4.22 It is emphasised that this is intended to provide for an understandable "rule of thumb" in making assessments of how local authorities might be judged given their borrowing and headroom position. It is not intended, for example, to indicate that an association that has drawn more than 80% of its facilities down from funders will automatically receive a V2 rating as there will be lots of other factors involved.
- 4.23 However, we would expect that the Regulator would raise concerns with an association that was more than 80% drawn down on its facilities if its business plan set out to invest further in new homes. The Regulator's expectation would very much be that the association would be actively seeking to extend its facilities with an appropriate buffer against risk and future planning prior to commencing investment.
- 4.24 In addition, given the need for long-term assumptions applied within the business planning process to be appropriate and robust, an association could not expect to embark on an investment programme that was not fully funded over its lifetime, from the outset.
- 4.25 In order to illustrate this, the chart below (overleaf) shows the typical relationship between maximum funding capacity (defined in terms of gearing and interest cover ratios), current maximum facility negotiated with funders, and projected levels of borrowing, where the three measures are projected in general alignment over 15 years given the intention to increase borrowing to invest in new development.
- 4.26 The chart shows projected borrowing at c80% of negotiated facilities capacity each year, with facilities renegotiated on the back of increasing capacity as the stock increases. The maximum facility is within maximum debt capacity and is successively renegotiated with funders prior to new borrowing being undertaken.
- 4.27 Such a pattern within the business plan, *all other things being equal*, could suggest a V1 rating.

Chart 10: illustrative business plan debt and borrowing relationships



### Application of viability criteria to local authority borrowing and headroom

- 4.28 We have cross-referenced the HRA borrowing and headroom position for 2015 and 2016 to the analysis above. The outcomes are set out in the figure below.

Figure 11: applying HRA headroom in a viability rating context

Classification	Borrowing compared to Facility/Capacity	Equivalent V Rating	2015 Headroom £m	2015 % Headroom	2016 Headroom £m	2016 % Headroom
GREEN	< 75%	V1	627	20%	586	18%
YELLOW	> 75%	V1/V2	561	17%	813	24%
AMBER	> 80%	V2/V3	1,479	47%	1,352	40%
RED	> 90%	V3/V4	495	16%	595	18%
<b>TOTAL</b>			<b>3,162</b>		<b>3,346</b>	

The figure shows that, in 2015, 63% of HRA headroom was in authorities that were within 20% of their debt cap. Though this figure had fallen to 58% in 2016, a significant majority of authorities are in the position where their current level of borrowing is greater than 80% of the maximum available (the Debt Cap, equivalent to funding facility).

The chart also shows that there is undoubtedly capacity for investment within authorities where the current level of borrowing is below 80% of the Debt Cap. However, a housing association looking to invest from a low base would first need to ensure that the facilities it had available for borrowing were useable for the long term within the business plan.

Put another way, an HA would almost certainly need to negotiate an increase in funding facility prior to embarking on such a programme.

The figure therefore illustrates that only around 20% of HRA headroom is within authorities where an immediate increase in borrowing could be justified in the context of financial viability.

- 4.29 The amount of HRA headroom in 2016 totalled £3.346billion. If it is assumed that an average all-in development cost for new social housing might be c£140-145k per unit, this headroom, if 100% geared towards investment, could deliver c22,500 new homes.
- 4.30 However, c60% of this capacity is within HRAs where, were the Social Housing Regulator to give a view, they might suggest that investment should be delayed until further debt capacity was secured. In summary, the release of capacity to deliver c15,000 of these new homes would not be supported by funders and the Regulator if this capacity was within housing associations.

### Rationale for viability analysis

- 4.31 Housing associations and local authorities operate in a social housing financial and policy environment that has the potential for uncertainties. The expectations of the Regulator and the Government are that landlords hold sufficient financial capacity to address changes in business conditions, central government policies, economic conditions (for example inflation and interest rates), and changes in assumptions in general.
- 4.32 The business planning framework for HAs is highly developed, with a high degree of transparency to the Regulator and funders around the rationale for the assumptions and projections made within business plans.
- 4.33 Conversely, the business planning landscape for HRAs is less well understood, both at a national level by government, and in the context of the primacy of local decision making. There is the opportunity for HRA authorities to further develop their thinking in the light of the experiences of housing associations, and apply this in the context of the existing Local Government Prudential Code. This may assist in making the case for greater investment into new development alongside a sensible and more rational approach to the setting of the Debt Cap.
- 4.34 A fundamental principle within business planning is "*the greater the risk, the more should be held in reserve*". In order to inform such an approach, set out below is a description of the sources of risks and unpredictability within social housing business planning as they might apply in an HRA context alongside possible sources of predictability and stability, with the latter sources suggesting that a lower risk buffer could be sustained.

*Table 12: sources of risk and unpredictability, and stability in HRA business planning*

Sources of Stability	Comment
The HRA is part of an overall local authority and is part of the authority's General Fund	The HRA is therefore able to draw upon the effective operation of the authority's prudential indicators to deliver a stable funding environment.
Strong, secure and well-maintained asset base	HRA assets are almost universally able to be maintained into the long term, and therefore produce sustained revenue income from lettings.
Costs are managed tightly to income levels	Tight financial control over HRA costs generates net rental surpluses that are able to sustain increases in investment.
Sources of Unpredictability and Risk	Comment
Right to Buy	Asset sales are required at sub-market levels without any predictability of where they will fall, and tend to be well performing assets; there are also challenges in recycling receipts.
High Value Asset Sales levy	Uncertainty over whether this policy will be introduced, over what timeframe and the precise impact it would have.
Rent Policy	Changes in forecast income within short time frames undermine the financing of borrowing in long term plans.
Unforeseen expenditure pressures	Changes in regulations, building maintenance requirements etc which require additional expenditure. An example at this current time is the need to address essential fire safety works following the Grenfell Tower fire.

### Summary

4.35 The principal conclusions from this element of the analysis are as follows.

Local authorities cannot rely on their revenue reserves to act as a buffer against future business plan uncertainties to the same degree as housing associations. Therefore, there is the likelihood that many regard headroom within the Debt Cap as a form of buffer against future uncertainty.

All housing associations negotiate a maximum funding facility with the funders. Housing associations would not be expected to borrow up to their funding limit given the need for their business plans to hold buffers against risks within the plans.

The greater the business risks associated with a business plan, the more of a buffer against unforeseen changes in circumstances is required.

Utilising an assessment of the equivalence for housing association viability ratings through a proxy of %age borrowing compared to prevailing funding facilities, only around one third of HRA borrowing headroom sits in authorities that, all other factors being equal, would unequivocally achieve a V1 Rating.

The consensus view amongst HA finance directors is that they would seek to extend facilities when borrowing reaches 80% of the current maximum.

Around three-fifths of HRA headroom sits in authorities where borrowing is greater than 80% of maximum facility (for HRAs, this is the Debt Cap). If the Social Housing Regulator were applying a viability rating to these authorities, there is a risk that this would contribute to a rating which would at best be V2. Best practice within HA financial management suggests that, above this benchmark, associations would seek to extend their facilities.

One fifth of HRA headroom sits in authorities where borrowing is greater than 90% of the maximum facility (Debt Cap). Applying a viability rating could risk a V3 rating or lower depending on the precise position, and other factors.

Whilst the total amount of HRA headroom could, if utilised pound-for-pound on new development, deliver c22,500 new homes, the headroom to deliver c15,000 of these homes is within authorities that are within 20% of their debt cap. If this were the capacity position within HAs, the Regulator and funders might be critical of authorities borrowing to build those 15,000 homes without first extending their capacity.

The key lessons to learn from regulation of the housing association sector are therefore that:

Acting to reduce policy uncertainties would improve the equivalent viability rating for authorities in a regulatory context by reducing the amount required to be held as buffers against risk. Such uncertainties in an HRA context primarily relate to the Right to Buy, future policies towards asset sales, and rent policy.

Allowing authorities to present business plans with future increases in their Debt Cap allowing the maintenance of headroom against potential future risks in the plan, would be the equivalent of the regulatory requirement on housing associations to negotiate increased capacity with funders prior to embarking on a development programme.

### 5. Commentary on Findings

#### Headlines around borrowing and repayment behaviour

- 5.1 Total headroom is less than the analysis produced by CLG in the spring of 2017, though the analysis has since been corrected. It is important that published analyses around borrowing and headroom levels are accurate and kept up to date.
- 5.2 Overall, whilst HRA headroom has increased since 2013, this is partially in line with stock loss from the Right to Buy and other disposals.
- 5.3 From 2015, there is some limited evidence of retrenchment around borrowing levels, principally driven by a step-up in Right to Buy sales since 2014, and policy uncertainty following the general election in 2015, particularly around the possibility of the High Value Asset Sales policy being implemented and the announcement of a 4-year rent cut. The reduction in borrowing levels is not therefore significant in this context.
- 5.4 The majority of headroom, 60% - or the equivalent of 15,000 new homes on a £ for £ borrow-to-invest basis - sits in authorities within 20% of their debt cap.
- 5.5 Only a small number of authorities have very large un-invested borrowing capacity - there is actually some evidence that some of this is being released.
- 5.6 The overwhelming majority of authorities are managing their borrowing in the context of their business planning – with marginal increases or reductions representing the ebb and flow of day-to-day financial management in the HRA, as opposed to actively borrowing or actively repaying debt.
- 5.7 The evidence suggests that only a small number (perhaps no more than a handful) are actively repaying debt as a policy objective.
- 5.8 The principal narrative arising from the analysis of trends in borrowing and headroom levels is one rooted in: *"Authorities would borrow to invest with more confidence but the financial and policy environment has been particularly uncertain since 2014.15."*

#### Learning lessons from the Housing Association sector

- 5.9 Closeness to borrowing capacity within individual housing associations is a function of their investment and business planning activity, supported by relatively generous grant settlements, since the mid-1980s. Business planning is highly developed and soundly regulated.
- 5.10 For local authorities, closeness to the debt cap has been, and remains to a large extent, a function of the historical and technical position before 2012.

- 5.11 Local authority mindsets have changed since 2012; they now reflect a more long-term, developed and sophisticated approach to business planning, which see headroom as a buffer held against future risks in the business plan, rather than the Debt Cap as a "spending pot".
- 5.12 This longer term, risk-based view of the business plan and borrowing is likely to become further embedded as time moves further on from 2012.
- 5.13 Our analysis has sought to post the question: *How would the HCA assess the viability of HRA business plans?*

Overall, the answer, spending up to capacity before understanding what further capacity there might be is not good business behaviour and would be actively criticised by the Regulator in an HA context.

The reserves position within housing associations add to the narrative – on average, HRAs are relatively tight to an externally imposed borrowing capacity which is increasingly outdated over time, and HRAs have much less in revenue reserves to call-on to address spending pressures.

- 5.14 Conversely, there is a *quid pro quo* in relation to the HA sector: whilst HAs have the regulator as a backstop, they are exposed to the marketplace for private finance; HRAs are able to limit housing-related exposure to risks through being part of the wider local authority, and acting within the Local Government Prudential Code.

### Authorities want to invest

- 5.15 All councils need new homes, of all types and tenures. We have yet to come across a local authority anywhere that does not want (or need) more social and affordable housing. There is widespread openness to add to the delivery from housing associations.
- 5.16 Our analysis suggests local authorities will invest, given policy clarity and the opportunities to do so.
- 5.17 Whilst most of the headroom in HRAs is, for historical reasons, within 20% of the debt cap, this is significant in a self-financing environment given three principal policy uncertainties – memory of the old subsidy system is fading fast and mindsets are changing. If this headroom were in housing associations, not only would there not be investment until new facilities negotiated, the Regulator might be critical of such investment.
- 5.18 Authorities are also delivering on multiple fronts, incorporating HRA delivery and delivery via newly created local housing companies. Recent research published by the Smith Institute<sup>10</sup> suggests that there are now over 150 companies in operation around England, many focused on the delivery of new affordable housing. The growth in companies proves that councils have the appetite and is testament to the innovation and ingenuity of local authorities in responding to policy challenges.

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<sup>10</sup> <http://www.smith-institute.org.uk/book/delivering-renaissance-council-built-homes-rise-local-housing-companies/>

Companies are a really key development in the debate around the operation of the Debt Cap in that where authorities see the opportunity to accompany investment in housing with the ability to earn a proportionate return and exercise sensible control over the business, they are investing.

### Government position

- 5.19 Given that borrowing for investment into new council housing in the HRA is accounted for as public expenditure by Government, there is rightly concern around the basis upon which control over borrowing levels is exercised. Without a fundamental change in the rules applying to public sector capital investment, local authorities accept that control is required - and that any future relaxation of rules around the HRA Debt Cap would not mean a free-for-all on borrowing.
- 5.20 Until 2012, successive governments utilised the subsidy system to control borrowing by gathering rental surpluses centrally, thereby limiting the scope to finance debt costs within the HRA.
- 5.21 In the run-up to the self-financing settlement, the Government's, specifically the Treasury's, view on releasing rental surpluses to local control was that this provides the potential risk for *profligate* authorities to borrow both extensively and outside of the direct control of government.
- 5.22 Technically, therefore, the Government continues to regard borrowing ceilings as public expenditure, funded by taxation/government income, and any increase in the Debt Cap would be an addition to public expenditure.
- 5.23 Borrowing ceilings are already accounted for in the national accounts. If the Debt Cap were raised, this would need to be funded nationally. If the Debt Cap were to be abolished, the addition to public funding would only be to the extent that borrowing began to exceed existing the prevailing Debt Cap in any area.
- 5.24 This approach to the treatment of HRA borrowing within the national accounts highlights a fundamental difference in approach between central and local government. The government regards council housing as housing that continues to be subsidised, despite the realisation of net rental surpluses from all council housing authorities since 2012.
- 5.25 Local authorities, alongside colleagues in the housing association sector, view social housing as an investment, which in the right business planning context, can earn a return on the investment. Central to making the case to government for relaxation of the Debt Cap - either as part of a national policy initiative or via bespoke authority settlements - is to adopt the mindset that new homes are an investment, and that financing all or part with investment from borrowing is a sensible and rational long-term decision.
- 5.26 Such a change in mindset might require government (central and local) to come to an agreement that the Debt Cap should no longer be seen as a *Funding Allocation* (a form of centralised subsidy), rather be seen as *Investment* as part of a sensible and long-term business plan.

- 5.27 For such an agreement to be realised, the Government must be persuaded that borrowing behaviours are part of an overall long-term business plan taking into account future income projections, spending needs (both capital and revenue) and the needs for investment in new homes delivery:
- When local authorities do not spend up to their Debt Cap, this is being sensible, building in risk buffers and protections, essentially acting like a business, and increasingly these behaviours are becoming the norm the further on from 2012 that plans develop.
  - Sensible businesses would not borrow to fund assets over which there was limited control over future retention and disposal, and where realisation of receipts is unpredictable.
  - At the same time, sensible businesses would not invest beyond the capability of the business plan to cover the costs of borrowing and investment.
- 5.28 The analyses set out within this report should not be seen as advocating the abolition of maximum ceilings on borrowing within Housing Revenue Accounts. On the contrary, the comparison with the housing association sector highlights that all housing businesses are subject to maximum investment capacity constraints.
- 5.29 Within the HA sector, maximum capacity is determined through partnerships with funders and the regulator. Within local authorities, the setting of borrowing and investment limits within the Prudential Code has been deemed a success since the Code's introduction in 2004.
- 5.30 The operation of both sectors suggests that the Government should consider the case for adopting a new approach to the setting of maximum borrowing limits within HRAs placing them firmly within the Prudential Indicator framework within the Prudential Code. This would have the advantage of adapting a system that has already operated effectively for 13 years without excessive borrowing, whilst allowing local authorities to operate their HRA business plans in much closer alignment with the housing association sector.