

## Briefing Paper

### The Financing of Council Housing

**Adrian Waite – November 2005**

It could be said that in 2005 Council Housing has reached a crossroads. July 2005 was the deadline for completing housing stock options appraisals and for getting them signed off by government regional offices. Many authorities have opted to do stock transfers giving them the challenge of managing a large scale voluntary transfer successfully and the challenge of continuing to provide housing services as an enabling authority. Other authorities have opted for stock retention, but many realise that retention does not mean 'no change' and there are doubts about the long term sustainability of stock retention. Arms Length Management Organisations are established in many authorities and more will be established next year, yet the main function of arms length management – the achievement of the 'decent homes standard' – will be completed in 2010. This raises the question of how arms length management organisations will develop and what their future will be after 2010.

Many people have been concerned about creating a 'fourth way' for Councils to raise finance to achieve the 'decent homes standard' and more. However, it can be considered that in 2005 the campaign for the 'fourth way' ran out of time. The only Councils with retained stock will be those that are able to achieve the 'decent homes standard' within existing resources and those Councils never needed the 'fourth way'. Meanwhile the Councils that could have benefited from the 'fourth way' have been obliged to opt for arms length management or for large scale voluntary transfer.

This leaves Councils with a number of challenges:

- How to create effective business plans for the Housing Revenue Account
- How to react to actual and potential changes in the housing subsidy regime
- How to develop sustainable financial strategies
- How to identify alternative financing options
- The financing of arms length management and retention authorities after 2010

In preparing housing revenue account business plans that will be considered 'fit for purpose' there is a need to demonstrate long-term sustainability. It appears that the Office of the Deputy Prime Minister considers that long-term sustainability means balancing the housing revenue account and financing enough capital expenditure to maintain the decent homes standard for at least ten years.

The housing subsidy system has a significant effect on the level of resources that are available to local authorities. Rent restructuring and the associated changes in housing subsidy mean that government will set all social rents centrally in 2012, will take all the proceeds away from local authorities through the guideline rent mechanism within the housing subsidy calculation, and then give councils back in management, maintenance and major repairs allowances what the government consider they should need to spend.

The reforms to the calculation of management and maintenance allowances that were introduced in 2004 coupled with significant real increases in these allowances are designed to ensure that management and maintenance allowances are set at realistic levels by 2012 when rent restructuring is in place. In theory, Councils should have sufficient in management and maintenance allowances to fulfil their management and maintenance obligations.

Similarly, Major Repairs Allowances, when they were first introduced in 2001, were designed to cover what local authorities need to spend on ongoing major repairs to sustain the decent homes standard. Councils are also receiving Supported Capital Expenditure that is designed to assist with financing the investment that is required for the decent homes standard. Councils that have opted for retention or arms length management, as part of their housing stock options appraisals have demonstrated that they can finance the decent homes standard through the resources that they have available including the major repairs allowance, supported capital expenditure and arms length management funding where applicable.

So, if a Council can demonstrate that it can achieve the decent homes standard with existing resources, and following 2010 it can rely on management, maintenance and major repairs allowances that are calculated to be at an appropriate level, why should any Council have a problem with long term sustainability? Why are so many Councils concluding that sustainability after 2010 is a problem?

One cause of unsustainability being modelled is the treatment of management and maintenance expenditure and allowances. Some authorities have traditionally had levels of expenditure on management and maintenance that exceed the management and maintenance allowances and calculate that this will continue despite the increases in allowances at a national level. Does this mean that management and maintenance allowances are still too low? Or that their distribution is still wrong? Or that the Councils concerned are spending too much – either through providing a high level of service or through being inefficient? The assumptions that Councils make on inflation can also have an effect. Many Councils assume that in the long term management and maintenance costs will increase in real terms, while management and maintenance allowances will increase in line with inflation only. This automatically creates a deteriorating position on the housing revenue account. Some authorities are modelling significant savings in management and/or maintenance but most are not. In view of the conclusions of the Gershon report should efficiency savings be routinely included in financial projections?

While the Major Repairs Allowance was originally designed to finance sufficient expenditure to maintain the decent homes standard, many Councils are now projecting a higher level of expenditure to sustain the decent homes standard than they are projecting in major repairs allowance. One reason for this is the assumptions that most Councils are making about inflation. Major Repairs Allowances are usually projected to increase in line with inflation, while the cost of major repairs is projected to increase in real terms. These assumptions often lead to an 'investment gap' that increases as time goes on. Again, in view of the conclusions of the Gershon report should efficiency savings be routinely included in financial projections?

Most authorities have found that there is no 'headroom' in their housing revenue accounts to support prudential borrowing. This is because management and maintenance allowances are only just sufficient to cover planned expenditure on management and maintenance, while actual and guideline rents are converging. However, there are some authorities that are planning to make significant use of prudential borrowing to meet the decent homes standard or even a higher local aspirational standard. They can only achieve this if they spend significantly less on management and maintenance than is included in their allowances. However, is this realistic in view of the fact that management and maintenance allowances are supposed to be set at the level of need to spend and that most authorities find them inadequate in the long term? Alternatively, does it demonstrate that management and maintenance allowances are more than adequate and that Councils should have no difficulty in adjusting their expenditure to the level of their allowances whatever that might be?

Developing a sustainable financial strategy for capital requires consideration being given to both expenditure and financing. To establish what expenditure is required an authority needs not only a robust stock condition survey but also an effective consultation with tenants about their aspirations that should inform a local investment standard. In some cases authorities need to consider demolitions or partial stock transfers to avoid the need for unaffordable expenditure on housing where the costs of achieving and sustaining the decent homes standard.

On financing authorities will be able to rely on the major repairs allowance, but decisions need to be made about prudential borrowing, revenue contributions to capital outlay and capital receipts. Careful consideration needs to be given to projections of the housing revenue account to see whether any 'headroom' exists or can be created to support prudential borrowing or revenue contributions to capital outlay. Capital receipts can be allocated to either the housing revenue account or the general fund, but where capital receipts are allocated to the housing revenue account this affects the Council's ability to finance its general fund programme. With the provision of new affordable housing and private sector renewal rising up the social housing agenda this will become an increasingly difficult matter to resolve.

Government grants are available, especially where housing investment can be seen as part of a broader regeneration package. The private finance initiative and small scale stock transfers are also way of introducing private finance to social housing.

Developing a sustainable financial strategy for revenue requires consideration being given to both income and expenditure. As rents and subsidy are controlled by government, Councils can only increase their income through improving control of voids and bad debts and developing other sources of income including service charges. On the expenditure side there is a need for authorities to be proactive, identifying the level of expenditure that is required and affordable and developing strategies to ensure that expenditure can be contained at that level. This includes considering whether there is a need to create 'headroom' in the housing revenue account to support the capital programme. It is important to consult with tenants on the level of services that they consider to be appropriate and whether they would be prepared to pay service charges to cover their cost. There is a need to move away from traditional incremental budgets (cut the repairs and maintenance budget to balance the housing revenue account) to zero based budgeting. There is a need to look at economies and efficiencies in the light of the Gershon agenda including making savings in management through use of information and communications technology and making savings in repairs and maintenance through more effective procurement.

The Office of the Deputy Prime Minister has identified the ingredients of a fit for purpose housing revenue account business plan. These include:

- Strategic Context
- Effective Consultation
- Stock Condition
- Current Performance
- Resources
- Priorities
- Options
- Action Plan
- Progress to Date
- Accessibility
- Conclusions

South Derbyshire District Council carried out a housing stock options appraisal that concluded that stock retention was not sustainable in the long term. However, following consultation, the Council decided that stock retention was their preferred option. This led to the Council establishing a working party of Councillors, Officers and Tenants, supported by an independent financial consultant, to carry out a fundamental review of the housing revenue account business plan. This resulted in some fundamental changes being made to the business plan and to the Council's budgets and management, to ensure that stock retention could deliver the decent homes standard and long term sustainability. The main changes were:

- Increased tenant participation in business planning
- All assumptions reviewed as part of a zero-based review of budgets and projections
- More capital receipts were applied to the housing revenue account
- Savings in management costs were identified

It is likely that the government will introduce significant changes to the method of financing council housing in the near future.

First, it is likely that the economies and efficiencies identified by Gershon will be incorporated into the financing of council housing. Management, Maintenance and Major Repairs Allowances will be adjusted to reflect assumed savings. Councils will then have to make those savings in practice.

Second, it is likely that capital expenditure will be supported from direct grants rather than through providing housing subsidy to support prudential borrowing. Furthermore, it is likely that resources will be focused on new affordable housing rather than the improvement of existing council housing stock.

Thirdly, it is likely that councils' debts will be restructured to support authorities with arms length management organisations coming out of the housing subsidy system.

Fourth, it is likely that the government will use their powers to set housing subsidy in a non-formulaic manner.

The Audit Commission published a report 'Financing Council Housing' in June 2005. It considered that there are six objectives that the government should be attempting to achieve through the housing subsidy system:

- Provide local accountability for council housing management, investment and stock condition
- Encourage and reward high performance, minimising perverse incentives
- Provide a customer focused approach to the provision of housing and housing services in a local market setting
- Establish an equitable relationship in each locality between charges, service standards and investment in council housing and neighbourhoods
- Promote self sufficiency for each Council, while allowing Councils to respond flexibly to the circumstances of the local market providing stability and predictability in their relationships with their tenants
- Support the government's objectives for council housing

The Audit Commission's recommendations were that:

- Government should review the council housing subsidy system:
  - Releasing from the system those authorities that can be self financing, linked with high performance
  - Giving a specific focus on solutions for those authorities that currently rely heavily on the system
  - Ensuring that any re-designed system incorporates the six principles identified by the Commission
  - Pending any reform of the system, the government should produce an annual report on the national housing revenue account to improve accountability
- Government should consider how the local housing revenue account could reflect broader landlord costs, not just those associated with housing revenue account dwellings. This would produce a better match between national priorities and local choice, result in greater equity between local authority and housing association tenants and support the government's liveability agenda

The government has not issued a formal response to the Audit Commission's report so it is unclear which of these recommendations, if any, will be acted upon.

For authorities with arms length management organisations, as well as for the arms length management organisations themselves, an important question is the future of arms length management organisations, especially after 2010 when the decent homes standard will be achieved. The question is that, as arms length management organisations were established to deliver the decent homes standard, what will be their role after 2010?

The government's wish to increase the supply of affordable housing may be the key to the future of arms length management organisations and it is likely that arms length management organisations will be given a bigger role in the development of new affordable housing. It has already been noted that it is likely that arms length management authorities will withdraw from the housing subsidy system following a debt restructuring exercise. However, despite this the sustainability issues will be similar to those faced by retention authorities as it is likely that the debt restructuring exercise will be based on the same data as the housing subsidy calculation. However, it is likely that arms length management organisations will have more potential than retention authorities to generate income from outside the local authority.

After 2010, the financing of arms length management and retention authorities is likely to be different to the present situation. There will be no more arms length management organisation funding and no more supported capital expenditure. Revenue budgets will be controlled through housing subsidy (or debt restructuring) and capital expenditure will be supported through the major repairs allowance. In his situation Councils and arms length management organisations will need to be proactive in managing their resources and additional resources will be primarily dependent on accessing other budgets.

Councils looking for alternative financing options will look principally at the Private Finance Initiative, the inclusion of housing in wider regeneration schemes, and developing freedoms and flexibilities for arms length management organisations. In view of the history of the Private Finance Initiative in housing, it will be interesting to see whether it finally takes off as a way of financing investment in council housing.

The housing stock options appraisal process that has been carried out under the Communities Plan has resulted in many authorities opting for either stock retention or arms length management. In both cases the local authority remains the landlord. As part of the housing stock options appraisal, Councils should already have identified strategies to achieve the decent homes standard by 2010. However, sustainability after 2010 depends on the proactive management of council housing. Councils that wish to move beyond sustainability will have to be even more innovative and this is most likely to be possible where there is an arms length management organisation.

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