

**TITLE OF REPORT : LENDING TO HOUSING ASSOCIATIONS**

REPORT OF THE HEAD OF FINANCE, PERFORMANCE AND ASSET MANAGEMENT

**1. SUMMARY**

- 1.1 At the 28<sup>th</sup> January 2013 Finance, Audit and Risk (FAR) Committee, Members requested that this area was reviewed to establish whether NHDC should include this as an option in its investment strategy, and that a report on this review was brought back to the FAR Committee for consideration.

**2. RECOMMENDATION**

- 2.1 That the Committee notes the conclusion reached in this report (at 8.8) that the Council should not include this option as part of its investment strategy

**3. REASONS FOR RECOMMENDATIONS**

- 3.1 As highlighted in this report, lending to a Housing Association would not generate sufficient financial benefits to the Council to make such a proposal attractive and viable as part of its Treasury Management strategy. Also, lending to a Housing Association would provide less security for Council funds than other investment options already utilised.

**4. ALTERNATIVE OPTIONS CONSIDERED**

- 4.1 The initial query from Members asked that NHDC considered lending funds to North Hertfordshire Homes. As outlined in the section on State Aid, this consideration should be widened to any Housing Association of sufficient size, and possibly not just restricted to Housing Associations.

**5. CONSULTATION WITH EXTERNAL ORGANISATIONS AND WARD MEMBERS**

- 5.1 Consultation has been undertaken with the Portfolio Holder for Finance & IT.

**6. FORWARD PLAN**

- 6.1 This report does not contain a recommendation on a key decision and has not been referred to in the Forward Plan.

## **7. BACKGROUND**

- 7.1 FAR Committee requested a report to explore whether NHDC would consider lending funds to a Housing Association (Registered Social Landlord) at a mutually agreed interest rate, i.e. higher than NHDC can obtain via its Treasury Management function, but lower than a HA would have to pay a commercial lender to borrow. The initial question related particularly to lending to North Hertfordshire Homes (NHH) and so that option is considered specifically, alongside a more general consideration regarding lending to third parties.
- 7.2 At Member request, NHDC Officers had briefly explored this idea in Autumn 2010, specifically in terms of North Herts Homes (NHH), but concluded that NHDC could obtain better rates of interest via our current Treasury Management Strategy than NHH were prepared to pay and so no further investigation was undertaken.
- 7.3 Additionally consideration had to be given to Treasury Management policies in relation to the stewardship of public funds, i.e. that security of funds was most important, followed by liquidity (i.e. ability to recall funds at short notice in the event of unforeseen circumstances) and only then is yield a relevant factor. This remains the case at the time of this report.

## **8. ISSUES**

Specific recent developments are outlined below:

### **8.1 NHDC Treasury Strategy**

#### **8.1.1 Credit Ratings**

The Council's counterparty list for Treasury investments comprises mostly UK building societies (which may or may not be credit rated) and UK banks with a credit rating greater than BBB, but also includes other Local Authorities, and Public Corporations (Credit ratings are provided by credit rating agencies, such as Fitch, Moody's and Standard & Poor).

#### **8.1.2 Credit Ratings Scores**

A credit rating evaluates the credit worthiness of a debtor and is determined by credit ratings agencies. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government; including non-public information obtained by the credit rating agency's analysts. Credit ratings are not based on mathematical formulas. Instead, credit rating agencies use their judgment and experience in determining what public and private information should be considered in giving a rating to a particular company or government. Each agency has its own specific range, however ratings tend to range from AAA as the highest rating to C (or D) as the lowest.

- 8.1.3 Some Housing Associations nationally are credit rated, although NHH is not. It should also be noted that, under the current Treasury Management Strategy, funds will not be lent to any Building Society that has assets of less than £0.3bn. For Building Societies with assets in the range £0.3bn to £1bn, the maximum amount of investment is £4m. Therefore it is assumed for the purposes of this report that, if a lending approach were to be adopted, then the same limits would be applied.

#### **8.1.4 Interest rates achieved**

The average rate of interest achieved on investments by NHDC compares very favourably to our Hertfordshire neighbours. This is mainly due to our investment strategy which permits investments to be placed with non-rated building societies. This is in contrast to many authorities who will not lend to the building society sector unless they have a sufficiently high credit rating (as per their individual strategies), prefer to keep investments to less than one year and have taken a more risk averse position with regards to counterparties. NHDC will place funds for up to two years in general, and possibly for three years if specifically approved by the Strategic Director for Finance, Policy and Governance.

- 8.1.5 The NHDC Treasury Management approach therefore already demonstrates a greater risk appetite than in many other authorities.

#### **8.2 NHDC Legal Position**

- 8.2.1 If NHDC were to introduce the proposed lending policy, the legal documentation envisaged would include a loan agreement between the Council and Housing Association (HA) containing the terms of the loan. A view would need to be taken as to whether the loan would be secured or unsecured on assets (and which assets as Housing Associations have generally already borrowed against their housing stock). If it is to be a secured loan, then a legal charge would be required. Guarantees and/or indemnities may also need to be considered. Therefore, if a scheme was to be pursued, specialist legal advisers would need to be instructed to draw up the financial agreements. The Council may also require specialist financial advice on the proposals. The costs involved are not quantified at present.

#### **8.3 Current Considerations**

- 8.3.1 Comment has been made that the housing stock held by a HA should provide sufficient security against which to lend funds. However, in relation to the particular instance of NHH, it must be pointed out that this stock formed the security against which NHH borrowed considerable funds at stock transfer and therefore is not available as security a second time (this is likely to be case for any HA). This would add further to the risks to be borne by the council.

#### **8.4 NHH Balance Sheet**

- 8.4.1 To illustrate the above point, the NHH latest annual accounts (to 31<sup>st</sup> March 2012) show that NHH had total assets of £300 million, partly funded by £261million of loans and £39 million of reserves.
- 8.4.2 HA's are classified as "Industrial & Provident Societies" and therefore do not enjoy the same financial protections as wholly Public Sector bodies, i.e. they have more flexibility to trade, but can also go out of business.
- 8.4.3 NHH has a sophisticated capital structure and treasury policy to underpin its operations, which also raises the question as to whether NHH would wish to put in place the additional protections required by NHDC as pre-conditions of a loan (e.g. legal agreements to secure the loan) and whether a mutually agreeable interest rate (and period) could be established.

The following is taken from NHH Annual Report and Financial Statements for financial year 2011/12:

“NHH have a long term syndicated loan facility comprising a bank and a building society, from which they have borrowed at both fixed and floating rates of interest. Funds have also been generated via bond debt issues. Interest rate swaps are used to manage the Group’s exposure to interest rate fluctuations and to secure the interest rate profile that can be supported within the 30 year Business Plan Model.

The Group’s treasury strategy includes maintaining an interest rate management aim that focuses on achieving cost savings through holding short-term debt but not missing the opportunity to tie into historically low long-term rates. At the year-end, 67% of the Group’s borrowings were at fixed rates after taking account of interest rate swaps (2011: 73%).

The Group has approved loan facilities of £285m and will seek to increase these loan facilities as opportunities arise.”

- 8.4.4 It should be borne in mind that the banks which currently lend to NHH at a particular interest rate will have assessed the risk to them of lending to NHH against the security NHH may be able to offer and the interest rate offered will be influenced by the assessed risk. If a bank, whose core business is making such lending decisions has arrived at the requirement for a particular interest rate, on what grounds would a local authority risk public funds and undercut the bank?

## **8.5 What do other Local Authorities Do?**

- 8.5.1 Other Local Authorities (in Hertfordshire and beyond) have been contacted on this question. No respondents lend to HA’s as part of their Treasury Management strategy.
- 8.5.2 This topic has also been raised on CIPFA’s Technical Information Service online forum. This has approximately 160 member councils, however no council has responded to confirm they undertake lending of this nature.

## **8.6 Advice from Sector Treasury Advisors**

- 8.6.1 The Sector view is that lending to a HA could involve no change in strategy as it may not be seen as an investment decision in itself, instead the authority could be said to be using housing powers to increase, or maintain, the supply of social housing in the area. However, that is not the basis on which this topic is being considered (the basis for consideration is to obtain better rates of interest) and it would clearly involve placing public funds with third parties and therefore represent a certain risk to public funds, whether described as an investment or not.

## **8.7 Worked example - NHH**

- 8.7.1 Assuming no changes to the current Treasury Management (TM) Strategy, NHH just meet the minimum £0.3bn total assets threshold applied to Building Societies. This would define a maximum investment of £4m. Also note that, under the current TM Strategy, investments are usually for two years maximum, with specific Strategic Director of Finance, Policy & Governance approval required for any longer deal. It is not in the Council’s interest to tie up its assets for longer periods.
- 8.7.2 Current interest rates achievable by NHDC are 2% (and this is also the percentage at which 10 year gilts are being issued by the Bank of England). We would therefore need to ensure that we achieved at least 2%, plus an additional premium to cover increased

risk and also further premium for all expenses in drawing up an agreement and any longer timescales that might be required. The Council is charged with proper stewardship of public money for all council tax-payers of North Hertfordshire and has to act in a way that protects their interests. On £4m, 2% represents £80k pa. If we assume a rate of 4% (for example) could be agreed with NHH, this would represent £160k pa, i.e. an increase of £80k pa. Whether this assumed rate of interest is sufficient to adequately address NHDC's risk exposure is not presumed in this report.

- 8.7.3 It should be noted that specific costs would be incurred in terms of legal expenses in drawing up the agreement, possible insurance requirements and any other risk mitigation measures considered necessary to ensure security of funds. NHH already has significant debt secured against its assets and so the option of securing an NHDC loan effectively in this way may not be possible, even if we wished to do so.
- 8.8 The conclusion reached by NHDC Officers is that lending to a Housing Association is unlikely to generate sufficient benefits to make such a proposal attractive. Achieving higher yields from investments is a secondary issue, with the primary considerations being security and liquidity of funds.

## **9. LEGAL IMPLICATIONS**

- 9.1 The statutory powers that could be used for this proposal depend upon the strategic intent of the Council and on any existing or new policies. If the purpose of the loan is to primarily promote social housing in this area, then the relevant powers would be in the Housing Act 1985, Section 111 of the Local Government Act 1972 (Subsidiary powers of local authorities) and Section 1 of the Localism Act 2011 (General power of competence). If the Council was to enter into a mortgage contract with a borrower, then housing powers could include lending. If a scheme was set up under Housing Powers, then the probability is that the Council would be exempt from FCA (Financial Conduct Authority) registration under paragraph 47 of Financial Services and Markets Act 2000 (Exemption) Order 2001.
- 9.2 If the promotion of housing was not the prime objective, but the investment decision was (as is the case here), then Section 1 of the Localism Act 2011 (General power of competence) can be used, but there should be a rigorous assessment of policy and strategy to justify this. If powers under the Localism Act or Local Government Act were used to enter into a direct loan agreement, then again the probability is that the Council would be exempt from FCA registration.
- 9.3 Consideration would need to be given as to whether the offer of assistance may be deemed as State Aid as this would have ramifications for the Council, not least in that it may influence the rate of interest that would have to be charged. State Aid refers to a prohibition on European Union member states granting financial assistance or resources in a way that distorts competition and inter-state trade within the EU.
- 9.4 The law on state aid is extremely complex particularly concerning dealings with Registered Social Landlords because the circumstances when they are deemed public bodies are not clear. Once the details of any proposed scheme were known, specialist advisers should be asked to assess whether the Council would be in breach of any state aid provisions and if so, what, if any, mitigating actions might be appropriate. These actions could include widening the remit of any proposed scheme, should it be decided to proceed, beyond that of Housing Associations only.
- 9.5 Should the Council wish to consider proceeding with this initiative, the details of any proposed scheme would be discussed with NHDC's external auditors prior to

implementation. Budgetary approval would also be required in order to engage specialist advice.

9.6 The FAR Committee's powers include the power to provide effective scrutiny and overview of financial matters including 'To consider the Council's approach in relation to Treasury Management'.

9.7 There are other legal references contained in the main body of the report.

## **10. FINANCIAL IMPLICATIONS**

10.1 The financial implications arising from this activity are contained in the main body of the report. The overall conclusion reached is that the option under consideration, lending to HA's, is not progressed.

10.2 Section 25 of Local Authorities (Capital Finance and Accountancy) ( England) Regulations 2003 requires that 'the making of an advance or the giving of a grant or other financial assistance to any person, whether for use by that person or by a third party, towards expenditure, which would, if incurred by the authority, be capital expenditure' is treated as capital expenditure. It would therefore be essential to ascertain the exact nature of any loan that would be made as this would also influence whether any repayment of the loan is a capital or revenue receipt.

10.3 DCLG Investments Guidance makes clear that investment priorities should be security and liquidity, rather than yield. The guidance "defines a prudent investment policy as having two objectives: achieving first of all security (protecting the capital sum from loss) and then liquidity (keeping the money readily available for expenditure when needed). Once proper levels of security and liquidity are determined, it will then be reasonable to consider what yield can be obtained consistent with those priorities."

10.4 The guidance does not prescribe where funds may be placed, only that proper measures are in place to ensure the above and for assessing and mitigating risk.

10.5 There has been recent press coverage of the decision by Moody's rating agency to downgrade the credit rating of 26 Housing Associations (although it should also be noted that a number of large Local Authorities, e.g. Birmingham, were also downgraded). However this should be considered alongside the downgrading of the UK overall.

## **11. RISK IMPLICATIONS**

11.1 The risk implications arising from this activity are contained in the main body of the report and Section 10.

11.2 The NHDC Treasury Strategy already demonstrates a greater risk appetite than many other authorities. In any approach taken the aim is to ensure that proper procedures are in place for assessing and mitigating risks.

11.3 The Shared Internal Audit Services annually reviews the NHDC approach to Treasury Management and procedures for dealing with Investment Risk in accordance with CIPFA and best practice as adopted in the Council's Treasury Management Strategy.

The results of their audit provides members with an assurance that the risks are well managed and considers that good practice is being observed. The most recent audit is coming to a conclusion and will give a substantial assurance.

## **12. EQUALITIES IMPLICATIONS**

- 12.1 The Equality Act 2010 came into force on the 1<sup>st</sup> October 2010, a major piece of legislation. The Act also created a new Public Sector Equality Duty, which came into force on the 5<sup>th</sup> April 2011. There is a General duty that public bodies must meet, underpinned by more specific duties which are designed to help meet them.
- 12.2 In line with the Public Sector Equality Duty, public bodies must, in the exercise of its functions, give **due regard** to the need to eliminate discrimination, harassment, victimisation, to advance equality of opportunity and foster good relations between those who share a protected characteristic and those who do not.
- 12.3 As described under Legal implications above, the proposals contained within this report relate to the ability of NHH to secure additional funding against their housing stock, to further their housing provision within the district and furthermore, under the Localism Act, to enable Council investment benefit with the extra positive of assisting additional or better quality housing. These could be seen to assist the Council in fulfilling its intention to assist its more vulnerable individuals within the district, and certainly those with housing needs. However, there are also risks described which identify circumstances where the loaned funds may not be readily available to the council, which could directly affect the ability of the council to provide some or all of its existing services to the wider North Hertfordshire community. This may also have an adverse impact on those within the community that exhibit a protected characteristic.

## **13. SOCIAL VALUE IMPLICATIONS**

- 13.1 As the recommendations made in this report do not constitute a public service contract, the measurement of 'social value' as required by the Public Services (Social Value) Act 2012 need not be applied, although equalities implications and opportunities are identified in the relevant section at paragraphs 12.

## **14. HUMAN RESOURCE IMPLICATIONS**

- 14.1 There are no direct Human Resource implications arising from this report.

## **15. APPENDICES**

None

## **17. CONTACT OFFICERS**

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**18. BACKGROUND PAPERS**

none