Where is housing heading?

Why is it important to change local authority borrowing rules?

July 2014

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In December 2013, the Chartered Institute of Housing (CIH) began a new series of policy discussions on the key issues facing housing over the next five years.

Two years after the coalition government published its housing strategy *Laying the Foundations*, and 18 months ahead of the General Election, we wanted to take the opportunity to pause and consider developments since 2010: where we have ended up, what’s worked, what hasn't, what we've learnt about the policy positions of the main parties and where things might be heading next.

We've commissioned a series of leading commentators to give us their views on these and other issues across different policy areas over the coming months. In this ninth essay, CIH policy adviser John Perry explores the arguments for changing local authority borrowing rules to allow councils to build more homes, and the options for change.

We hope you will enjoy the essays and that they will stimulate debate over the critical period in the run-up to the election.
9. Why is it important to change local authority borrowing rules? The arguments and the options for change

Most local councils in England want to build more homes and take advantage of the greater financial freedom they've had since council housing finance was reformed in April 2012. In doing so they face many challenges, some of which can’t easily be overcome. For example, some have limited supplies of land. But one obstacle that could be tackled if government wanted to is the borrowing caps that were imposed when self-financing began. They stop many councils from making extra investment that could easily be paid for from their rental incomes.

For much of this year there have been articles in the housing press about the borrowing rules and whether and how they should be changed. This essay sets out the case, answers many of the criticisms and shows how changed rules could lead to more homes being built at genuinely affordable rents.

What are the borrowing caps and why were they put in place?

Caps on borrowing were imposed on each of 169 councils that had housing stock in April 2012, based on calculations under the old Housing Revenue Account (HRA) subsidy system. The caps impose limits on how much each council can borrow for council housing purposes. The limit includes the debt they already have: anything above this and still within the limit is called ‘headroom’. The impact of the caps is very arbitrary – some councils that need to borrow have no or limited headroom, others have significant headroom and may not need it.

The caps were put in place because government knew that within a few years of the start of self-financing councils would easily be able to afford to borrow more. All council borrowing affects government debt. So even though councils have to stick to prudential borrowing rules, these further limits were judged to be necessary. They mean that few if any councils can borrow as much as they could afford to do sustainably within the prudential rules.

At the same time, HRA borrowing is the only part of council debt that is capped. Furthermore, caps do not exist in Scotland, where councils can and do borrow within prudential limits, currently building almost to the same levels as in England (over 1,000 new units annually) even though Scotland’s population is only one-tenth that of England’s. The caps are also much tighter than when self-financing was originally planned by the last government – their Prospectus envisaged councils being able to invest in building 10,000 new homes per year.

Why relax the borrowing caps?

Starting with the potential to build more homes, there are seven main reasons for giving councils more borrowing freedom.

Building more homes
Since 2010, councils have been building about 1,500 new units per year – as against only 2-300 for many years before that. When self-financing started in April 2012 output received a further potential boost. According to a survey last year by the Association of Retained Council Housing (ARCH), councils’ current plans mean their output should rise to 4-5,000 new homes per year over the next five years.¹

In 2012 the report Let’s Get Building showed that, without the constraint of the borrowing caps, an extra 12,000 or so homes could be built per year over five years.² In total, therefore, councils’ output might rise to 16-17,000, at least for a period, if the caps were relaxed or removed. These figures have an element of speculation but are indicative of the potential ‘locked up’ in councils’ self-financed housing accounts which could be fully released if extra ‘prudential’ borrowing were to be allowed.

Achieving a 200,000 output target

Both the coalition government and the Labour party say they want to build at least 200,000 homes per year. Last year the G15 group received a report from Savills which showed how such a target needs to be based on enhanced output from each part of the housing industry.³ They recommended that the private sector raise its output to 130,000 per year, housing associations to 55,000 and local authorities to 15,000. Council house building is therefore an essential part of a 200,000 house programme and can only be achieved by giving local authorities (LAs) more borrowing freedom.

Making the most of self-financing

Councils are in a strong position to borrow. Their average debt per dwelling is only around £17,000 – which is similar on average to housing associations but is much more evenly spread across the sector. Because of this, councils typically have a gearing ratio (ratio of debt to equity) 50 per cent lower than that of developing housing associations (HAs). Let’s Get Building indicated current headroom of £2.8 billion within the caps but additional borrowing capacity of at least £20 billion if the caps were relaxed/removed.

Creating a fairer system

As well as limiting the borrowing power of the sector overall, the caps leave many councils with little or no borrowing power at all. As Figure 1 shows, around half of all councils are able to borrow only £10 million or less – enough to build only 80-90 homes if all the borrowing were spent on new build. Some councils with pressing needs have no borrowing headroom at all - they include Greenwich (11,000 on their waiting list), Dudley (6,000), Exeter and Harrow (4,000 each). Many others have to use all their headroom to invest in their existing stock (achieving and keeping to the Decent Homes Standard, ‘retrofitting’ houses to make them more energy-efficient, and so on). It means they have little or no capacity to build new homes even if they urgently need to.

¹ ARCH (2013) Innovation and Ambition.
³ Savills (2013) Additionality of Affordable Housing.
Putting less reliance on grant

Councils’ current plans show little expectation of receiving grant from the Homes and Communities Agency (HCA) – the ARCH survey showed expected grant contributions of only £4-20 million annually for a total capital investment programme (including significant investment in existing stock) of £1.5-1.7 billion annually up to 2015/16. Councils fund their investment mainly from reserves, revenue contributions, capital receipts and borrowing financed from rents.

Building at social rents

Soon all HCA-funded output by HAs will be at higher Affordable Rents. However, councils retain capacity to build at social rents and many wish to do so (or to produce a mix of social rent and Affordable Rent output). The ARCH study indicated that 50 per cent of LAs’ planned output is likely to be at social rents.

Releasing local authority land

Finally, much potential development land is linked to existing estates – whether redevelopment of obsolete property or use of spare land such as underused gardens, garages and so on. Councils (as landlords) are in the best position to release such land, taking into account residents’ views.

Are councils already borrowing up to the limits? If not, why not?

Despite the fact that it is only two years since self-financing began, there have already been complaints that councils aren’t borrowing as much as they could under the current system. This is one of the issues being looked at in the government’s Elphicke Review of local authorities’ role in housing supply. Concern has been fuelled by an Inside Housing survey which suggested that many councils are not yet using their available borrowing headroom to build new homes. Why might that be the case?

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4 See [www.gov.uk/government/groups/review-of-local-authorities-role-in-housing-supply](http://www.gov.uk/government/groups/review-of-local-authorities-role-in-housing-supply)
First of all, the Inside Housing survey took place only 22 months after self-financing began. It would be odd and indeed irresponsible if in that time councils had already used all their borrowing capacity, which extends over the 30-year life of their business plans. Some will have expensive debt on their books which they want to pay off, some may be able to finance their immediate investment needs from capital receipts or reserves, others may be cautious about taking on new debt when their income is under pressure from welfare reform.

Second, even for councils with available headroom, their first priority is bound to be their current stock. Although the government allocated funds to support councils to meet the Decent Homes Standard, this was only about half the funding judged necessary and was heavily skewed towards London. The rest have to fund the work from their own resources, and all councils need to fund the continuing investment to keep homes ‘decent’ (such as renewing obsolete kitchens and bathrooms) as well as in many cases putting more investment into the stock to achieve other aims such as their targets for energy efficiency.

Third, building programmes take time to get started, usually needing 3-5 years to ‘get on site’ from the initial decision to plan new development. Councils which have built homes in the last two years are mainly those which received funding under HCA programmes. It’s only really from 2014/15 onwards that we can expect to see the first new build ‘starts’ as a result of self-financing.

So, the case for change was that it would bring results in the medium term – over five years or more – not have an overnight effect. Also, the needs, capacities and political inclinations of 169 authorities are bound to vary considerably. The aim of reform isn’t to ensure all councils build to the maximum of their capacity, it’s to give the many that want to build new homes a proper chance to do so.

**What are the options around relaxing the borrowing caps?**

Essentially there are two strategic options: to relax the caps within current borrowing rules or to change the rules so that caps are no longer needed. The latter will need more explanation as it involves comparing UK borrowing rules with those that apply internationally

Option 1: relax or remove the caps *within current borrowing rules*

- no major change in the current financial regime
- *but* new borrowing counts towards government debt

Option 2: a *change of borrowing rules* to those that apply internationally (see below)

- removes LA housing borrowing from the main measure of government debt
- LAs would need to rely on the financial markets as housing associations do
- LA housing businesses operate within the same market disciplines that apply to HAs
• brings the UK into line with our competitors and accounts separately for borrowing by public corporations (including arms length management organisations (ALMOs) and directly managed council housing).

An alternative approach to the removal of the borrowing caps is to pursue a ladder of changes within option 1. For example, there could be a controlled bidding round for councils near to their borrowing caps, linked to new build plans; or the caps could be lifted to a new set level to make an additional allowance for new build for every council, or the caps could be index-linked and rise over time. A staged approach could be planned to lead to the full removal of the caps linked to new arrangements to ensure that any new borrowing is sustainable (i.e. potentially leading to option 2).

Criteria for the phased changes could include councils having robust governance arrangements, viable business plans, and a track record of delivering new build, as would be required for private sector borrowing from the financial markets.

Under option 1, government could at any time re-impose borrowing controls, either in specific cases or across the sector. This is therefore a low-risk option but with the major disadvantage that all the extra borrowing is ‘on the books’.

**Are there other alternatives to get borrowing ‘off the books’?**

Other alternatives to boosting investment in council housing have all been explored or are already used. Stock transfer is the most obvious. Most councils which now retain stock or have ALMOs are now unlikely to consider transfer as they will have rejected it previously and the incentives are now limited. Options to build on the ALMO model so that the council retains a stronger interest in the stock than is the case with transfer were examined in a 2011 report by the National Federation of ALMOs (NFA). None have so far proved feasible in practice. Finally, some have argued that ‘municipal housing companies in which the council has a controlling share (as in Sweden) would work. However, they would only avoid borrowing constraints if there were to be the same rule changes as under option 2.

**What change in borrowing rules would be required for option 2?**

This requires some technical explanation. The UK’s fiscal rules are based on targets for controlling the level of Public Sector Net Debt (PSND). However, PSND is a uniquely British measure; the main international measure of debt is known as General Government Gross Debt (GGGD). While it focuses on PSND domestically, the government has to report GGGD levels to comply with EU rules and it is the main measure used for international comparisons by bodies such as the IMF and OECD. Whatever changes the UK government makes, it still has to abide by rules which are monitored by an EU-wide body called Eurostat.

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6 NFA (2011) *Building on the potential of ALMOs to invest in local communities.*

The main difference in the coverage of PSND is that it covers the whole of government, including public corporations, while GGGD includes only central and local government borrowing. Council housing and ALMOs as a sector are now classified not as part of government but as ‘public corporations’. Other public corporations include bodies such as the East Coast Mainline, British Nuclear Fuels, Royal Mint, local airports, bus and tram companies, etc. None of these count as part of government when measuring debt according to the GGGD.

The UK government therefore has flexibility to decide whether or not any or all public corporation borrowing counts towards its domestic debt measure, as in any case it is already excluded by the international measure. A topical example is the part-nationalised banks, which are excluded from PSND and do not affect the UK’s debt measured by GGGD as they are public corporations. Changes of classification occur fairly often: for example Network Rail has recently been reclassified as a government body; further education colleges have been reclassified twice in the last few years and are now in the private sector despite the public subsidy they receive. A future government may well do the same with academy schools.

A change in rules could therefore be either:

- a general change (presumably as part of a new set of fiscal rules) towards measuring UK debt by accepted international criteria (including switching from PSND to GGGD as the main measure of debt); or

- a specific exemption for council housing, to treat its debt as outside the current debt measure (PSND); this would still comply with international measures since council housing debt is already excluded from GGGD.

Under either, there could of course be reporting arrangements (as there are with the banks) so that the new ‘off balance sheet’ borrowing is transparently monitored in the public accounts.

The case for change and further details of what would be required are set out in Let’s Get Building and in the recent summary Treating Council Housing Fairly.  

What further changes would be needed if LAs were to have the same borrowing freedoms as HAs?

The options above have become much more viable since self-financing began in April 2012, since councils have already put in place more realistic business plans, have in many cases separated out their HRA debt and are already making decisions about the more effective use of incomes, balances and reserves. The extent to which councils would need to further change their governance and accountability arrangements depends on whether option 1 or option 2 were to be pursued (and of course stages in option 1 could be used as steps to option 2, allowing time for and conditional on the necessary institutional changes).
Under option 2, to properly put council housing on a similar basis to housing associations with (for example) access to bond markets, other reforms would be needed. Briefly, these are:

- full separation of HRA from non-HRA debt where this has not yet taken place
- reporting and monitoring arrangements for total debt at national level
- financing of new debt (and, if possible, refinancing of old debt) from non-government sources (i.e. not the Public Works Loan Board, which is part of government)
- a comprehensive code of practice for self-financed council housing – this would incorporate the CIPFA Prudential Code
- a review of the mechanisms that would permit councils to borrow on the basis of their HRA income streams and assets (i.e. as HAs do) and the regulatory framework that would apply
- robust governance and risk management arrangements for each council housing business that provide the level of assurance and comfort that bond market investors require.

The last three points are vitally important as councils would be moving into new territory: at present their borrowing is guaranteed against their whole income stream and ultimately backed by government. New arrangements would be needed that meet the expectations of private funders who will require robust arrangements in case of default. Among the options that will need to be considered are how ‘arms length’ the council housing business should be – can it be run successfully from within the council or should LAs be required to put their assets in the hands of an ALMO (i.e. a wholly owned company)? And should council housing businesses be regulated by the HCA, as associations are? If so, what further changes would this require?

A staged approach to reform would create time to resolve these issues and for the new mechanisms to be put in place.

Wider obstacles to reform

Both Let’s Get Building and Treating Council Housing Fairly look in detail at the obstacles to these changes, and the former specifically considered City opinion in a separate study commissioned from Capital Economics. The main obstacles are resistance to change by the Treasury and possible adverse reaction from the markets. The main arguments in addressing these obstacles include:

- The UK is simply bringing itself into line with international rules.
- These rules already apply to foreign public corporations operating in the UK, for example, transport companies such as Arriva and energy companies like EDF.
- In the housing sector, councils and HAs effectively do the same job and should follow the same rules.
While it can be argued that council housing will still have an implicit government guarantee:

- protection could take the same form as with HAs, i.e. tenants and homes are protected but a failing organisation might need to be taken over by another entity so as to achieve this
- many bodies in the private sector (banks, utility companies) also effectively have a government guarantee, as we have seen.

- Transparency will be maintained and indeed strengthened.
- Market disciplines will apply, whereas they do not apply now.
- Overall controls will still be in place and in any case the potential sums involved are small in the context of overall expenditure and borrowing.

What are the prospects for a change in rules?

In the two years since self-financing began, there has been an unprecedented level of support for changes in the borrowing rules, including from the LGA, many councils of different political shades such as Westminster and Nottingham, and Boris Johnson the Mayor of London. The coalition government has so far rejected wholesale change and has made clear that the Elphicke Review can’t consider it. However, the government has recognised the tight constraints created by the borrowing caps, at least to some degree, by proposing to relax the caps in certain circumstances although with no more than an additional £300 million of borrowing being allowed.9

Labour spokespeople have argued in favour of reviewing councils’ borrowing capacity and it is being actively considered by the Lyons Review, set up by Labour and due to report later in 2014.10

The main argument for change is still the best one: it is vital if we are to address the pressing need to build more homes. The last time when house building was at or near 200,000 per year was in the late 1980s, when councils were contributing 15-20,000 new homes towards the total. At the zenith of England’s national housebuilding efforts in 1968, 40 per cent of all homes were built by councils. Whenever output by the private sector has been high, councils’ contributions have been high too and they have been working in partnership with the private sector. While models of housing supply have changed there is now widespread recognition that the necessary levels of housebuilding will not be achieved unless local authorities are fully engaged and contributing. They can only do this if they can take full advantage of the all-party reforms that were made in April 2012, so that they can invest the income from council house rents that they now control for the first time in many decades.

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