



# investing in council housing

The impact on HRA business plans

July 2016



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Written by John Perry and Glenn Smith (CIH) and Joanne Pitt (CIPFA).

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# \ foreword

The Government's aim to build one million new homes over the next five years is an ambitious one. In the aftermath of the EU referendum, with doubts about future investment in construction and about developers' willingness to commit to building new homes, the aim becomes even more challenging. If one million extra homes are to be built, all providers – private developers, housing associations and local authorities – will need to contribute.

In recent years local authorities have had a minor role in building new homes themselves, and a more important one in facilitating development by others. But the settlement which took effect in April 2012, when council housing became self-financing, opened a new opportunity for the 165 councils who are still landlords to begin to invest more in new housing. Self-financing led initially to councils planning to build at least 3,000 new homes per year, as against their output of only a few hundred homes in the early 2000s.

Four years after self-financing took place, output is only around half this figure. As the two professional bodies most concerned with housing management and housing finance in the social sector, CIH and CIPFA decided to work together to explore the current situation and what could be done to allow local authorities to play their full role in contributing to the target of one million extra homes. This report is the result. We believe we have developed a powerful and persuasive analysis which throws a spotlight on the issues which handicap local authorities' ability to make their full contribution.

Many of the obstacles to meeting the government's housing challenge are well rehearsed, but this analysis identifies some lesser-known policy changes that have undermined sensible and widely accepted reforms for self-financing of council housing. When made as recently as 2012, the reforms 'were intended to endure for the long term'. But key government decisions over the four years have critically reduced councils' capacity to invest in new homes.

Housing requires investment to support both building and maintenance. Long-term investment solutions require a stable operating environment. Policy changes such as rent reductions and the widening of right to buy have very materially affected councils' plans to build new homes and maintain existing ones. Our survey shows that the effects are similar whether the council is a big metropolitan authority or a shire district: the differences are ones of scale.

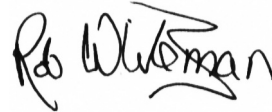
Mindful of the need to make best use of resources and to maximise all players' contributions to the Government's house-building aim, the report makes a series of recommendations aimed to restore the potential that was created by the 2012 settlement and allow local authorities to build at least to the capacity that was projected at the time.

The publication goes to press in the immediate aftermath of the EU referendum, and a potential shock looming over the UK economy that may well have severe consequences for the housing sector. However, there can be little doubt that demand will continue to be strong for good quality housing. Allowing local authorities more scope to invest and ensuring stability in their policy environment could be highly desirable elements of a policy aimed at weathering an economic storm.

We therefore urge the government to consider the report's finding and recommendations and to maximise the potential which was unleashed by the reforms to local authority housing that took place four years ago.



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Chief Executive, CIH



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# executive summary

## Self-financing for council housing and what was promised

Until 2012, council housing finance was controlled by government. Although council housing was by then generating a financial surplus, in the early 2000s councils were building fewer than 200 new homes in a year. Calls for reform led to a new settlement in April 2012, ‘intended to endure for the long term.’ The majority of councils took on £13bn in extra debt in order to become ‘self-financing’ and to invest more in new homes.

The coalition government made a number of promises to convince local authorities to accept the deal. Councils understood that they were taking on additional risks. Because the majority took on extra debt, the sustainability of their income was crucial. For the first time they were able to make robust 30-year business plans, but they would only stay robust if income could reliably be forecast and maintained. Unexpected and significant loss of income, of assets or of the ability to maintain service levels could all prejudice the viability of the plans. Yet although legislation allowed for the settlement to be reviewed, this can only be done by central government.

## Were the promises kept?

Although the Government has never called for extra payments from councils, beyond those made in 2012, it has made other decisions which have undermined the settlement:

- rent levels have had to be reduced to substantially below expected levels
- assets are being sold more quickly than anticipated
- welfare reform is making it harder to collect rents.

## What has been the effect on the settlement and on investment?

Our modelling shows that the cashflows available to local authorities have already dropped dramatically, even before taking into account other policy changes. Originally, self-financing offered potential capacity (if devoted solely to new build) for authorities to build more than 550,000 homes over 30 years. Inflationary changes have already reduced this to 160,000. With the rent reduction policy, capacity to build drops further to just 45,000 units over 30 years, no higher than levels currently being achieved. Government proposals on higher-value sales are likely to have a further impact unless there is appropriate compensation for any reduction in cashflows.

The survey of local authorities confirms that those with housing stock see considerable challenges over the next four years from the reduction in rental income and these can be seen in reforecast business plans and warnings over financial stability. Lack of information on the new policies has impacted very differently on mid-term financial planning by different authorities. While some have modelled all new scenarios even though many details are still lacking, others are taking a more cautious approach, waiting for details to emerge before recalibrating their plans.

Overall the financial uncertainty already appears to have affected the ability to build homes. For some this may lead to seeking alternative approaches such as the creation of housing companies that operate outside the Housing

Revenue Account (HRAs are the statutory accounting system for council housing<sup>1</sup>) but for many the reduction in rent and the erosion of assets have meant the reduction or abandonment of any growth ambitions.

The survey and modelling provide significant evidence that the April 2012 settlement has been undermined by policy changes since, that have sharply reduced incomes and the ability to invest. If the legislative provisions had allowed for a reassessment of the settlement to be triggered by either central or local government, then the latter would have a compelling case to require the settlement to be revisited. As it is, while local authorities can take limited protective action to maintain their viability by avoiding new borrowing (and hence cutting back on their investment plans) and by making revenue savings which inevitably affect service levels, only central government can restore the viability of the overall settlement.

## Recommendations

The recommendations below stem from the conclusions and are intended primarily to help local authorities to restore their investment plans to at least the levels available to them at the time of the settlement.

### Recommendations to Government

1. That the Department of Communities and Local Government (DCLG) reviews policy changes which have had ‘a significant material effect on [local authorities’] costs or income’ and considers mitigating those policy changes.
2. That such a review considers ways in which the investment potential of local authorities can be restored so that their business plans can once again be put on a sustainable basis and local authorities can play a full role in delivering housing supply.
3. In response to these findings, that it specifically considers:
  - a. Reviewing the remaining three years of the four-year reduction in HRA rents and replacing it with a less drastic requirement.
  - b. Allowing local authorities to retain the full extra income from the ‘pay to stay’ scheme.
  - c. Reviewing the effects of the next stages of welfare reform on HRA incomes, and in particular considering measures that would mitigate the impact of universal credit such as payments direct to landlords and twice-monthly payments (as already agreed for Northern Ireland).
4. That in relation to higher-value sales, the Government considers how best to fully compensate each authority’s business plan, by either:
  - a. allowing them to reinvest the receipt to generate a replacement income stream, or
  - b. letting them deduct the present value of residual costs from the sale receipt, or
  - c. permitting them to redeem debt, or
  - d. a combination of these.
5. That Government considers offering stock-holding councils a refreshed ‘deal’ including the points made here and, where necessary, some flexibility in borrowing caps, in return for specific commitments on new supply, including better use of assets and of local authority-owned land.
6. That Government reiterates the earlier commitment to long-term sustainable business plans and agrees to judge future policy changes against this objective, including those relating to welfare reform.

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**1** An HRA is a separate landlord account that any council with more than 50 council dwellings must maintain. It covers the income and expenditure that relates to the management and maintenance of the housing stock. It is a ring-fenced account intended to ensure that rents cannot be used to subsidise other council expenditure.

## **Recommendations to stock-holding local authorities**

1. That they urgently review their HRA business plans if they have not yet done so, taking into account the full range of factors covered in this report.
2. That local authorities consider (through the Local Government Association (LGA), Association of Retained Council Housing (ARCH) and the National Federation of ALMOs (NFA)) what 'offer' could be made to government to improve housing supply in return for commitments that would provide more stable HRA business plans.

## INTRODUCTION

# why is this study needed?

Until April 2012, the finance of council housing – its running costs and investment in the housing stock – was controlled by government. In part this was because, historically, council housing received considerable government subsidy. However, for several years this had no longer been the case, and by 2011/12 councils were paying across to government more than £700m in ‘surpluses’. Yet investment in new building, although it had started to recover somewhat, had in the early 2000s fallen below 200 new homes in a year.

Calls for reform, based partly on the argument that councils and tenants should have more control of their finances, and partly on the case for allowing them to use their potential to invest so as to build more homes, led to both major parties agreeing that council housing should become ‘self-financing’. This would require a rebalancing of council housing debt, between the majority of authorities that could sustain higher debts and those who would still need subsidy unless their debt were reduced. The settlement, heralded by the then housing minister as ‘a reform intended to endure for the long term’, took place on 1 April 2012. It involved the majority of councils taking on £13bn in extra debt while a smaller number had their debt reduced by £6bn, leaving the Treasury with a net surplus of £7bn.

At the time of the settlement, there were prospects of a significant increase in councils’ building programmes. But in practice the agreement set out in a joint statement by central and local government has been undermined by a series of subsequent policy changes. The much-anticipated boost in council building programmes has barely happened.

Local authorities are making a compelling case that recent changes in government policy are eroding the opportunities that were part of the self-financing settlement. As professional organisations whose members are closely involved with the long-term financial sustainability of public sector housing, both the Chartered Institute of Housing (CIH) and the Chartered Institute of Public Finance and Accountancy (CIPFA), who had both been engaged in the debates and detailed planning for the original settlement, were concerned about the changes taking place. The two professional institutes wanted to understand the impact government policy changes were having on long-term business plans. Both therefore decided to undertake this joint study to investigate how the changes had affected councils’ housing finances since April 2012, what the consequences were and what would be needed to help restore councils’ ability to invest.

The study is published to inform debate on how to deal with policy changes that are still taking place as the study has been in preparation. It reviews councils’ position now compared with what it was in April 2012, and against the promises made at the time. It makes recommendations to government and to councils on how to respond to these changes and how the government could help restore councils’ ability to invest in new homes.



# why councils need to invest in social housing

In England, 165 local authorities own some 1.6 million houses, providing homes to nearly four million people.<sup>2</sup> The council housing 'business' is worth about £9.5bn annually: that is to say, councils spend this amount on managing and maintaining their housing and (apart from a small amount of other income) tenants pay the same amount in rents to cover councils' costs. Despite popular misconception, at national level rents have covered costs without subsidy for many years; a fact officially recognised when council housing became 'self-financing' in April 2012. Council housing is a robust business and many councils want to use its financial capacity to fund new investment.

Why do they need to invest? The first main reason is that it is a crucial part of councils' proper management of their assets (not only houses but garages, commercial premises and land). Effective asset management means keeping them in good condition, assessing the potential for their improvement or better use, judging whether they meet current and potential future standards and customer expectations, and ensuring the overall sustainability of the estates and neighbourhoods where the homes are based. As every homeowner knows, houses are deteriorating assets which need constant investment or 'planned maintenance'. They must meet changing standards for safety, energy efficiency and a range of other requirements. For all of these reasons a long-term investment strategy is an integral part of asset management. At its most basic, it helps sustain the landlord's income: without it, stock will fall into disrepair, tenants will be less willing to pay rent, there will be higher turnover with costly void periods, and parts of the stock may become unpopular and even unlettable.

Most local authority landlords have experienced problems resulting from underinvestment in the past and want to avoid them in the future. Furthermore, as the Government's Housing Standards Review showed in relation to new housing,<sup>3</sup> current standards are often deficient in terms of energy efficiency, accessibility, security and other requirements. For example, the government's Fuel Poverty Strategy has a target that all dwellings achieve an Energy Efficiency Rating of 'Band C' or above: currently, just over half of council dwellings fall below this level and will require investment to meet it.<sup>4</sup>

The second main reason for investment is that all local authority landlords are also housing authorities, with broader statutory responsibilities that stem from the Housing Act 1985. They are required to 'consider housing conditions in their district and the needs of the district with respect to the provision of further housing accommodation'.<sup>5</sup> The duty overlaps with duties to assess housing need under the Planning Acts, which are covered by government guidance under the National Planning Policy Framework.<sup>6</sup> Councils are expected to judge the need for new affordable housing against indicators such as levels of homelessness, use of temporary accommodation, overcrowding and concealed households, inability to afford to buy, etc. New affordable housing can encompass tenures other than social rented housing, and of course housing associations and private developers (through planning agreements) are the biggest providers of new stock.

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**2** There are 325 English 'housing authorities': London borough, district, metropolitan and unitary councils which have overall responsibility for housing in their area. Roughly half of these councils used to run their own council housing, but no longer do so because they have transferred it to housing associations. This report concerns the remainder – the 'stock retaining' authorities which either manage housing directly or via ALMOs (arm's length management organisations).

**3** DCLG (2014) *Housing Standards Review – Technical consultation*. London: DCLG.

**4** DCLG (2016) *English Housing Survey: Headline Report 2014-15*, Chapter 2. London: DCLG.

**5** Section 8(1), Housing Act 1985.

**6** Set out at <http://planningguidance.communities.gov.uk/blog/guidance/housing-and-economic-development-needs-assessments/>

Why then do councils need to build themselves? Given that housing associations are often geared up to new building and can raise private finance to do it, there is general recognition that they will continue to be the main providers of new affordable housing. Most councils have nomination rights to housing association lettings in their area, through which they can discharge their housing duties. Nonetheless, there are several reasons why they might want to use their HRAs – the statutory accounting system for council housing<sup>7</sup> - to develop new homes themselves:

- **Building for letting at social rents.** Councils want more stock which is affordable to those on low incomes, as far as possible without tenants needing to access housing benefit. Lettings at social rents, which are currently about 13% of average adult earnings, are affordable to more people than those at affordable rents (almost 20% of earnings) or rents in the private sector (28%).<sup>8</sup> Housing associations' ability to build at social rents is now very limited.
- **Reconfiguring their stock.** Asset management strategies may identify council stock that is under-utilised or underperforming, cannot be economically improved and needs to be replaced (eg unpopular maisonette units).
- **Making better use of estate land.** Garden or back land might be potentially available for development in popular areas, but requires the landlord to undertake the development because of the nature of the site, the need to secure tenants' agreement, etc.
- **Meeting new demands.** The council's stock may be deficient in certain types, eg dwellings for larger families, and building them could enable tenant transfers which would make more efficient use of the stock overall.
- **Replacing right to buy sales.** Specific government rules encourage replacement, providing it is done within three years.

Of course, even councils that retain a housing stock do not necessarily have to build homes through their HRAs. A number have created council-owned companies or use their ALMOs to build non-HRA stock (eg for intermediate renting). Many have engaged in partnership or joint venture arrangements with developers and housing associations. This report will, however, focus on investment that is financed by councils through their HRAs.

HRA investment offers significant advantages:

- Self-financing of council housing, established under the coalition government, offers considerable investment potential while still allowing councils to meet prudential borrowing rules.
- Because rents are pooled in the HRA, costs can be shared across the whole stock.
- Council debt levels per unit are almost one-third lower than those of housing associations and their borrowing costs are low.

A detailed case for HRA-based investment by councils has been made elsewhere, notably in the NFA-led joint report *Let's Get Building* and in the NFA-SHOUT report by Capital Economics, *Building New Social Rent Homes*.<sup>9</sup> They make the economic case in terms of benefits to the local economy and in savings in housing benefit because of lower rents.

This report takes the case for council housing investment as having been made in these and other recent studies. As the next chapter shows, both the capacity and the need for HRA investment have existed for many years, and a series of policy developments and initiatives by different governments have aimed to release the potential of this investment.

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<sup>7</sup> An HRA is a separate landlord account that any council with more than 50 council dwellings must maintain. It covers the income and expenditure that relates to the management and maintenance of the housing stock. It is a ring-fenced account intended to ensure that rents cannot be used to subsidise other council expenditure.

<sup>8</sup> See Wilcox, S. *et al* (2016) *UK Housing Review 2016*, table 72. Coventry: CIH.

<sup>9</sup> See Perry, J. (2012) *Let's Get Building*. Coventry: NFA jointly with ARCH, CIH, LGA and CWAG; Capital Economics (2015) *Building New Social Rent Homes*. Coventry: NFA and SHOUT.

# why and how did council housing become self-financing?

If local authorities (or housing associations) are to undertake the types of investment described in chapter 1, a number of conditions must apply. A prerequisite is, of course, the need to invest combined with the organisational and political will to do so. The next condition is the ability to raise sufficient capital finance, usually through borrowing, as investment is a long-term commitment and it is normal to spread the costs accordingly. The need to borrow can also be reduced by, for example, having proceeds from property sales (capital receipts) that can be reinvested, or having access to government grants. A further condition is having sufficient income, within their control, to pay not only their day-to-day running costs but also the debt charges and other costs of new investment. For a social landlord, this income is principally their rents. Finally, a key requirement is a reasonably stable operating environment, so that the landlord can adopt a long-term business plan with confidence that key factors like rents and the ability to collect them, and other factors less under their control like interest rates and inflation, are predictable within certain safety margins.

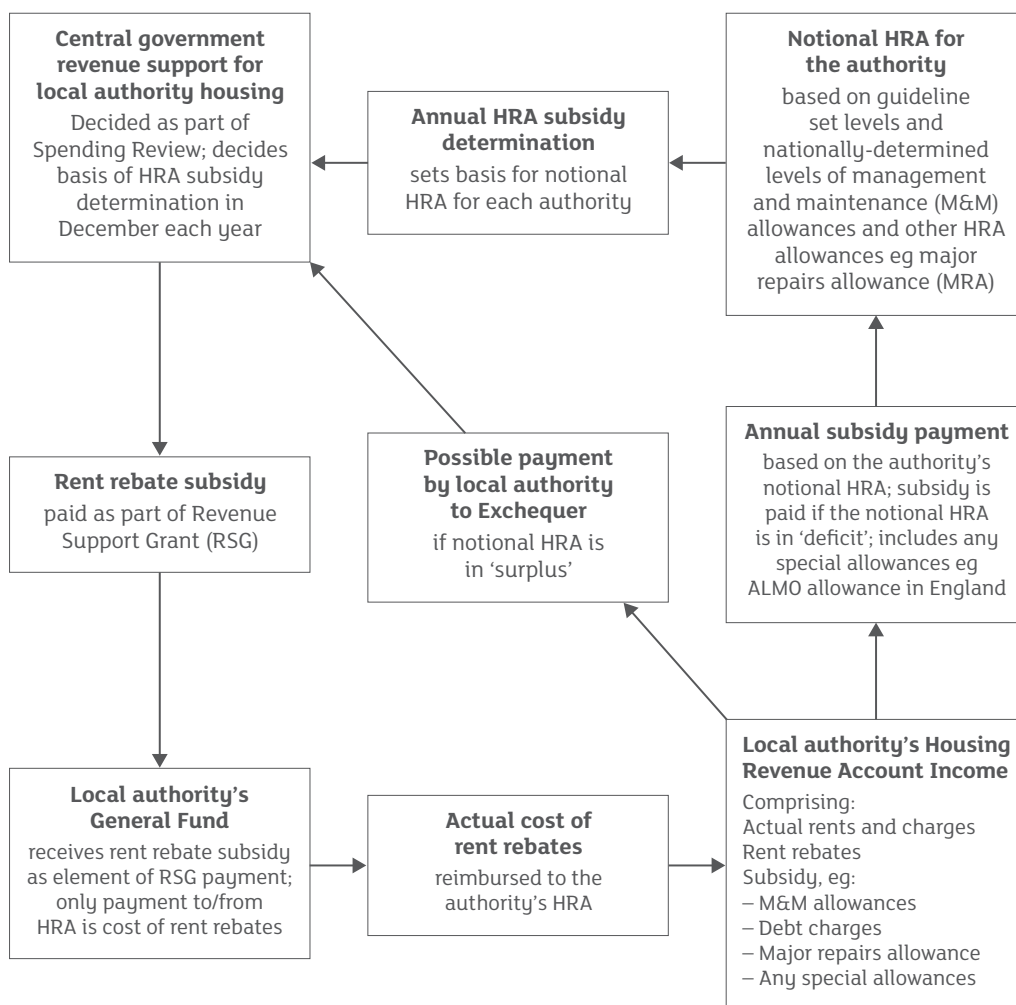
If such conditions are in place, councils and housing associations, faced with continuing and usually growing housing needs, are likely to be willing to make investment decisions that will often take 3-4 years to result in new or improved homes and which may involve financial commitments extending up to 30 years and beyond.

It would be possible to add other conditions to those listed above, but the list serves to make an important point. For roughly three decades from the late 1970s onwards, under both Conservative and Labour governments, local authorities were deprived of several of these key requirements. As a result, they were placed at a huge disadvantage compared to housing associations, in several ways:

- **The need and political will to invest** was common to both parts of the social housing sector, because although associations were mainly interested in building new homes, local authorities' most pressing need was to raise the standards of their existing stock. This was because it was generally much older and dating from periods when the imperative was to build quickly, often using innovative construction methods that had not stood the test of time. Apart from certain limited kinds of system-built housing that literally began to collapse and, with government financial support, were replaced, for more than three decades the general council housing stock developed a growing backlog of disrepair. The obstacles that councils faced in tackling it were related to the other three conditions.
- **Investment capacity** was severely restricted by government-imposed constraints on councils' borrowing, which made it very difficult to deliver capital programmes to tackle the disrepair backlog. Increasingly tight limits were also placed on their ability to reinvest the receipts from sales. This was particularly important given the introduction of the right to buy, which from 1980 to the present day has led to the disposal of almost two million homes, raising receipts of £43bn, but with much of the money going back to government rather than being reinvested by councils.
- Councils had **insufficient income within their control** as a result of policies which restricted rent increases (rents were typically held down to less than 10% of average male earnings at the time). The national HRA 'subsidy' system ( see Figure 1) that controlled council housing finance meant they had limited local flexibility over rents, since 'allowances' for management and maintenance were set nationally. Then from the mid-1990s, councils were collectively losing a proportion of their income through 'negative subsidy' payments they were required to make to the Treasury, which meant they were handing over the surpluses that could have financed additional investment in their stock.

- **The lack of a stable operating environment** arose from decisions on rents, allowances and ‘subsidy’ payments being made annually by central government, and for an individual authority they could vary wildly from year to year. As housing minister Grant Shapps commented in December 2010, ‘...councils have no certainty about future income, no ability to plan long term, and in practice few incentives to drive up efficiency’.<sup>10</sup>

**Figure 1: The complexities of the national HRA subsidy system 2004-2012**



Source: Garnett, D. and Perry, J. (2005) *Housing Finance*. Coventry: CIH.

In contrast to councils, during the 1980s housing associations increasingly found they had all these conditions in place. Once they were given access to ‘private’ finance in 1988 they were able to borrow more, supported for many years by increasing government grant. They enjoyed full control of their rental income. While for both housing associations and councils this income was underpinned by a relatively stable benefits system, associations could take more advantage of this, being encouraged by government to raise rents. Since 1988, associations have therefore been able to develop and sustain robust business plans and as a result have built over half a million new homes as well as ensuring the upkeep of their existing stock.

<sup>10</sup> Hansard, 13 December 2010, Column 61WS (see [www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm](http://www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm)).

But by the late 1990s council house building was down to a trickle of only 200-300 per year. It was to stay at that level until 2010. By 1997, councils also had a backlog of £19bn of disrepair as a result of chronic underinvestment in their stock.<sup>11</sup> It was therefore hardly surprising that various measures emerged to allow council housing to enjoy some of the advantages gained by housing associations and recover the ability to invest. Over the period to 2010, the most significant developments were:

- **Stock transfer.** By far the biggest and most successful initiative, this was piloted by Chiltern Council in 1988 and embraced by both Conservative and Labour governments. By 2015 it had resulted in almost 1.3 million dwellings moving across to the housing association sector. The new housing associations often created could take advantage of different borrowing rules, increased investment capacity and protection from the right to buy on new tenancies.
- **The Decent Homes Standard (DHS).** Adopted in 2000, this required the backlog of investment to be tackled, with the aim of eliminating non-decent housing by 2010. By the target date, 78% of council stock met the standard and now the proportion is 85%.
- **Arm's length management companies (ALMOs).** From 2002, councils began to set up such companies to take advantage of additional government subsidy towards meeting the DHS. By 2008, one million council homes were under ALMO management.
- **Piecemeal reforms to council housing finance.** A number of other reforms helped councils to develop more ambitious investment plans. For example, **rent restructuring** was adopted in 2002, with the aim of creating a similar rent regime for both parts of the social sector. Capital controls were ended in 2004 and replaced by **prudential borrowing**. And in 2009, councils became **eligible for social housing grant** for new build schemes.

However, councils which still had a housing stock were frustrated by their inability to invest in new housing and the continuing limitations they experienced when compared with housing associations. A number of measures were put forward, by government and by professional bodies such as CIH and CIPFA, for more radical reform of council housing finance and greater freedom to invest:

- **Changed borrowing rules.** Since 1995, CIH has made the case for a change in borrowing rules to bring the UK into line with international conventions, which would put local authorities and housing associations into the same category for these purposes, outside the constraints on government borrowing.<sup>12</sup>
- **A 'fourth way' for council housing** was argued for by a group of MPs and others from 2004, which would allow greater prudential borrowing freedom for councils.<sup>13</sup>
- **ALMOs demanded a long-term future** in 2005, in which they would become self-financing. In response, in 2006 the government published a review of ALMOs, although it focused mainly on short-term measures.<sup>14</sup>

What was to be the most promising development began originally in 2002 when the government published a consultation paper, *The Way Forward for Housing Capital Finance*.<sup>15</sup> In a section described as 'blue skies' thinking, it suggested options such as extra borrowing headroom for HRA investment, the restructuring of HRA debt (to create more borrowing headroom) and the ending of the HRA subsidy system. Such measures would:

*'...give councils the maximum management freedom and certainty and produce a "hands off" situation as far as central government was concerned.'*

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**11** DCLG (2009) *Memorandum to the Communities and Local Government Select Committee* (see [www.publications.parliament.uk/pa/cm200910/cmselect/cmcomloc/60/60we35.htm](http://www.publications.parliament.uk/pa/cm200910/cmselect/cmcomloc/60/60we35.htm)).

**12** See for example, Perry, J. (2014) *Why is it important to change local authority borrowing rules?* A CIH policy essay (available at [www.cih.org/policyessays](http://www.cih.org/policyessays)).

**13** The debate is summarised at [building.co.uk](http://building.co.uk) (see [www.building.co.uk/decent-homes-standard-the-fourth-way/3044716.article](http://www.building.co.uk/decent-homes-standard-the-fourth-way/3044716.article)).

**14** NFA with CIH and HouseMark (2005) *ALMOs – A new future for council housing*. York: NFA; DCLG (2006) *Review of Arm's Length Management Organisations*. London: DCLG.

**15** ODPM (2002) *The Way Forward for Housing Capital Finance*. London: ODPM.

The proposals were effectively put on ice, and not fully examined until 2006. In that year the Government announced a pilot self-financing scheme which would cover six high-performing local authorities, and whose details would be developed through a working group with practitioners. This reported in 2008, and immediately led not to a pilot but to a wider review of the potential for council housing to become self-financing.<sup>16</sup> DCLG concluded this further review in 2009 with the consultation paper *Reform of Council Housing Finance*, finally paving the way for a self-financing settlement. A project team was established by DCLG, which included CIH and CIPFA, to develop a voluntary 'offer' to local authorities. In March 2010, DCLG then published its 'prospectus' for the settlement, *Council Housing: A real future*, but action was halted by the General Election two months later.

However, this time the delay was a short one. The new housing minister, Grant Shapps, quickly indicated that self-financing would go ahead under the coalition government, no longer via an 'offer' but as a compulsory reform. DCLG published its plan in *Implementing Self-financing for Council Housing* (February 2011) and then, in July, *Self-financing: Planning the transition*. This prepared the ground for a radical new settlement for council housing finance to take place on 1 April 2012. Just ten years after self-financing had first been put forward by government as a 'blue skies' proposition, it was to become a practical reality.

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<sup>16</sup> DCLG (2008) *Self-financing of council housing services: Summary of findings of a modelling exercise*. London: DCLG.

# what did the self-financing settlement mean?

Although the self-financing settlement that took effect in April 2012 was broadly a cross-party measure, there were some crucial differences from the plans put forward by the previous government. In this chapter, we briefly recap what the settlement was and what it aimed to achieve, highlighting some of the differences and some of the key elements finally included.

The broad intentions of the settlement were the same when it took effect in April 2012 as when it was first put forward in the 'prospectus' of March 2010:

- It recognised that the old HRA system had fallen into disrepute because of its complexity, lack of transparency and unfairness; its annual determinations had become increasingly volatile and unpredictable. It aimed to create a new system that devolved financing and accountability to local authorities, giving councils more flexibility to respond to the needs of local people and more ability to plan long term, driving up services and improving efficiency.<sup>17</sup>
- It accepted what government had recognised in 2009, that expenditure on housing services was too low.<sup>18</sup>
- It would be based on 'a fair valuation of their housing business that guarantees all councils receive a sustainable level of debt that they can afford'.<sup>19</sup> In essence, this left some councils with additional debt that recognised the future surpluses they would have paid to the Treasury (but would no longer pay), while some had their debt reduced to a level that was sustainable against their rental income (this is discussed further below).
- The council sector as a whole would have potential to borrow to invest against the spare capacity in their business plans, although Treasury would retain controls over the amount of debt taken on, by placing 'borrowing caps' on councils individually.

Within these broad aims there were, however, some crucial differences between Labour's offer and the plan implemented by the coalition:

- Some councils were planning to resist a voluntary scheme, so the new government decided to make it compulsory with a single settlement date applying to all stock-holding councils.
- Labour had planned to allow councils more investment potential within the settlement, by factoring in capacity which (it claimed) would enable councils to build 10,000 new homes per year 'before the end of the next parliament'.<sup>20</sup> Additionally, it intended to allow councils to keep all capital receipts (which at that time were modest because of a decline in the right to buy). Neither of these elements were in the final scheme.
- There were important differences in the settlement itself, which depended on an assessment of the value of the council housing business based on various assumptions, which then had to be broken down into individual settlements at local authority level. Under Labour's original scheme, councils would have made a net payment to the Treasury of just over £3bn; under the scheme as implemented, the payment rose to some £7bn.

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<sup>17</sup> DCLG (2010) *Council Housing: A Real Future: Prospectus*. London: DCLG.

<sup>18</sup> DCLG (2009) *Evaluation of management and maintenance costs in local authority housing: Report of findings*. London: DCLG.

<sup>19</sup> Hansard, 13 December 2010, Column 61WS (see [www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm](http://www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm)).

<sup>20</sup> Letter from John Healey MP to Sarah Webb, Chartered Institute of Housing, 27 April 2010.

There were other detailed differences, some favourable to local authorities and others less so. However, there was general agreement that the final settlement adequately recognised the need to spend more and was a robust and enduring replacement for a discredited ‘subsidy’ system. All councils would benefit to some degree: even those borrowing more so as to pay money to the Treasury would incur lower debt costs than the amounts they had been losing in ‘negative’ subsidy payments. The settlement was therefore commended to local authorities in a joint statement by the housing minister and local government representatives in October 2011.<sup>21</sup>

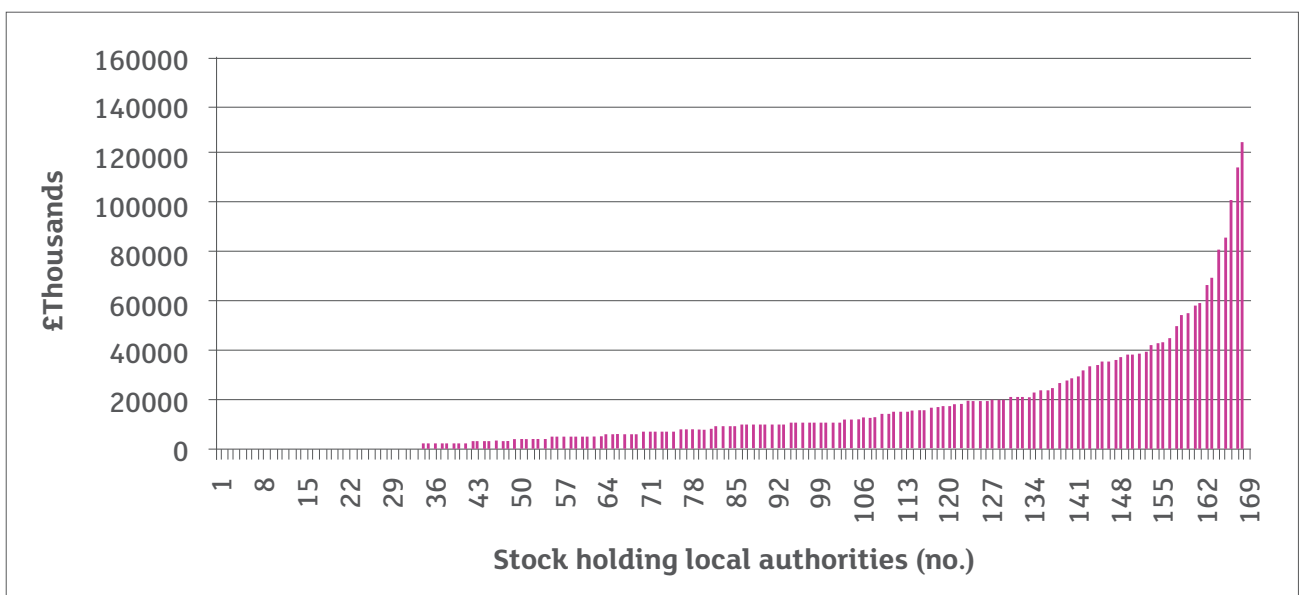
In the light of experience since April 2012, it is worth recording some key elements that the settlement put in place:

### Investment and borrowing caps

In the absence of the earlier commitment to provide for a substantial new build programme, the settlement provided ‘headroom’ across the sector for £2.8bn of additional investment, distributed very unevenly across individual authorities by imposing borrowing caps on each one (28 were left with no borrowing headroom at all – see Figure 2). Councils were advised that the ‘borrowing limit should provide a stable framework within which local authorities can plan and manage their housing business’.<sup>22</sup> Government added that:<sup>23</sup>

*‘Ministers have stated during the passage of the Localism Bill that we will not subsequently reduce the aggregate borrowing cap, or the borrowing caps for individual councils, which are set out in the original self-financing determinations. Councils will therefore be able to plan ahead on the basis of those caps.’*

**Figure 2: Distribution of HRA borrowing headroom by local authority (April 2012)**



Source: ARCH (2013) *Innovation and Ambition*. Coventry: ARCH.

### Right to Buy sales

These were assumed to follow established regional patterns over the previous three years, leading to compensation of £862m to the Treasury being built into the settlement.<sup>24</sup> Future receipts were to be split 75:25 between the Treasury and the local authority, but this was later altered to 70:30.

<sup>21</sup> See [www.gov.uk/government/publications/self-financing-for-council-housing-joint-statement](http://www.gov.uk/government/publications/self-financing-for-council-housing-joint-statement)

<sup>22</sup> DCLG (2011) *Implementing Self-financing for Council Housing*. London: DCLG.

<sup>23</sup> DCLG (2011) *Self-Financing: Planning the transition*. London: DCLG.

<sup>24</sup> DCLG, *op.cit.*



## The HRA ring fence

One of the many complexities of the HRA is that it is not a distinct ‘account’ in the physical sense: the monies are held in each local authority’s overall accounts, but identified separately. Because local authorities have considerable freedom to move money within their accounts, rules were necessary to define HRA activities and to prescribe if and when money could pass into or out of their HRAs. These rules, usually known as the HRA ‘ring fence’, were introduced by the Conservative government in 1990, principally to stop money being moved from a council’s General Fund into the HRA. Under Labour’s ‘prospectus’ for self-financing, the ring fence was to be maintained and made more ‘transparent’ through new guidance, which was included in draft in the prospectus. The coalition’s ‘implementation plan’ for self-financing also retained the ring fence, but the additional guidance was thought to be unnecessary. It said: ‘We expect local authorities to take their own decisions, rooted in the principle that “who benefits pays”.’<sup>25</sup>

## Rents

The settlement made assumptions about future HRA income, principally from rents. The crucial ones were:

- guideline rents would converge with formula rents in 2015/16
- rent increases of just above inflation were assumed, year on year after 2015/16
- a limit was imposed on individual annual rent increases of RPI + 0.5% + £2 per week up to ‘convergence,’ and thereafter for annual increases in formula rents of RPI + 0.5%.

The government added that ‘it does not have any plans to change the national rent policy set out above’ and that it was committed to allowing councils ‘to keep all the money they receive from rent’. In advice for tenants, it said ‘the level of rent you pay will continue to be a decision for your council’.<sup>26</sup>

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<sup>25</sup> DCLG (2011) *Implementing Self-Financing for Council Housing*. London: DCLG, para. 5.2.

<sup>26</sup> DCLG (2011) *Self-Financing: Planning the transition*. London: DCLG.

# what has happened since April 2012?

### *'A reform intended to endure for the long term'*

Grant Shapps, Minister of State for Housing and Local Government, 2010

When Grant Shapps presented the self-financing proposal to parliament in December 2010 he called it 'a reform intended to endure for the long term'. At the same time the Localism Bill, then passing through Parliament, contained a power to reopen aspects of the settlement. This provoked calls for the power to be clearly defined, 'leaving no doubt about the circumstances under which it could be used'.<sup>27</sup> The Government's response said that the provision would allow 'a further adjustment to the debt allocated to local authorities if a future policy change has a significant material effect on their costs or income' and that the measure was 'designed to protect both councils and the Exchequer'. It added that '...the Government is committed to assessing over the long term the impact of policy changes that may affect landlord income and the case to make good any losses or address any gains'.<sup>28</sup>

Has the settlement proved to be as enduring as promised four years ago? Although no use has yet been made of the Localism Act powers to reopen the settlement, there have been a number of significant changes which would have altered the basis of it, had they been known at the time. Here we look at five issues that affect the settlement's sustainability: investment and borrowing caps, the HRA ring fence, right to buy and other sales, rent policy and welfare reform. The first four issues are dealt with in the order in which they were introduced in the last chapter although, as we shall see, rents policy is becoming the most significant and changeable factor. Welfare reform is a factor not included in the settlement but very pertinent to it.

## Investment and the borrowing caps

This was perhaps the most controversial aspect of the settlement. The settlement allowed only for the maintenance of the existing stock, with any headroom (see Figure 2 in chapter 3) arising as a by-product of local circumstances. This led to various assessments of what investment might take place or could have taken place without borrowing caps being imposed. The potential of councils to borrow prudentially in 2012 via their self-financed business plans was assessed by the NFA to be some £20bn over five years if no caps had been in place, whereas councils were limited in practice to a far lower £2.8bn. The NFA argued that a potential 170-230,000 extra homes would have been built in total, if all the spare potential had been devoted to new build.<sup>29</sup> An assessment of self-financing by ARCH a year later showed that councils had plans to invest an average of £9,000 per unit in their stock and would build 25,000 new homes by 2018, but could increase output by a further 60,000 homes if borrowing constraints were removed.<sup>30</sup> In 2014 a new survey by the LGA suggested 28,000 homes would be built within five years, growing by a further 48,000 if caps were removed.<sup>31</sup> On the other hand, it was also argued in 2014 that councils had still not fully used their headroom under the existing caps.<sup>32</sup>

**27** DCLG (2010) *Council housing: A real future – Summary of responses*. London: DCLG.

**28** Hansard, 13 December 2010, Column 61WS (see [www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm](http://www.publications.parliament.uk/pa/cm201012/cmhansrd/cm101213/wmstext/101213m0001.htm)).

**29** Perry, J. (2012) *Let's Get Building*. York: NFA jointly with ARCH, CIH, LGA and CWAG.

**30** ARCH (2013) *Innovation and Ambition – the impact of self-financing on council housing*. Coventry: ARCH.

**31** LGA (2014) *LGA Self-Financing Survey 2014*. London: LGA.

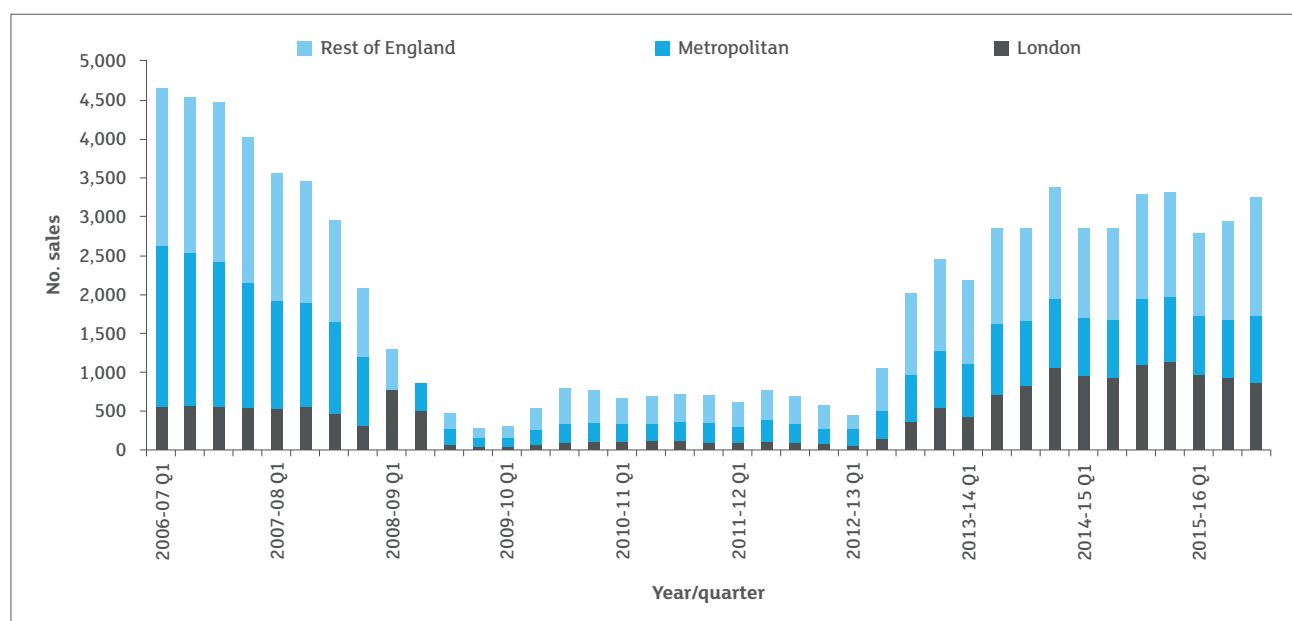
**32** Cooper, K. (2014) 'Feast or famine', in *Inside Housing*, 27 June (see [www.insidehousing.co.uk/home/analysis/feast-or-famine/7004397.article](http://www.insidehousing.co.uk/home/analysis/feast-or-famine/7004397.article)).

Various calls for action to allow more investment have been made. CIPFA argued that the caps should be removed, because prudential borrowing rules would offer sufficient control in themselves,<sup>33</sup> and their view was endorsed by the Communities and Local Government Select Committee.<sup>34</sup> CIH, NFA and ARCH agreed with this, but went further in arguing for changed borrowing rules that would make caps unnecessary.<sup>35</sup> A report from Westminster Council on behalf of four local authorities supported this case.<sup>36</sup> The GLA Housing Committee called for individual councils to be able to request higher caps, or for councils to be able to ‘pool’ their borrowing headroom to use it more effectively.<sup>37</sup>

It should be stated that in the four years since the settlement the government has not sought to reduce the borrowing caps, but its response to suggestions for change has been limited. For example, it set up the Elphicke-House review into the role of local authorities in housing supply, but it specifically ruled out a change in borrowing rules in setting the terms of reference. However, the final report did present arguments made by different councils on this issue and called for some flexibility.<sup>38</sup> The government also announced a scheme to allow extra HRA borrowing of £300m over two years to 2016/17 through a competitive bidding process among local authorities, but conditions imposed (such as requiring sales of high value stock) meant there was only limited interest.

## Right to Buy and other sales and receipts

**Figure 3: Quarterly right to buy sales by type of local authority, 2006-2016**



Source: DCLG (2016) *Right to Buy Sales in England: October to December 2015*. London: DCLG.

As Figure 3 shows, prior to the settlement in April 2012, Right to Buy sales had slowed down considerably as a result of the state of the market and the Labour government’s reductions in discounts. For four years, sales were below 3,000 per year. This was about to change dramatically as, coinciding with the settlement, the government ‘reinvigorated’ the right to buy, offering higher discounts and other changes.<sup>39</sup> Sales increased to almost 6,000 in

<sup>33</sup> CIPFA (2013) CIPFA disappointed at missed house building opportunity, press release, June 27. London: CIPFA.

<sup>34</sup> House of Commons Communities and Local Government Select Committee (2012) *Financing New Housing Supply*. London: HoC.

<sup>35</sup> Perry, *op.cit.*; ARCH, *op.cit.*

<sup>36</sup> Westminster Council (2011) *The Case for Borrowing for Investment in Housing*. London: Westminster Council.

<sup>37</sup> GLA Housing Committee (2013) *Right to Build: What’s stopping councils from building more housing?* London: GLA.

<sup>38</sup> Elphicke, N. & House, K. (2015) *From statutory provider to Housing Delivery Enabler: Review into the local authority role in housing supply*. London: DCLG.

<sup>39</sup> DCLG (2012) *Reinvigorating right to buy and one-for-one replacement*. London: DCLG.

the first year and since then have reached over 12,000. The new sales levels had not been factored into the settlement, but a rule change was designed to allow the Treasury and local authorities to have the same income from receipts as they had expected before the change, while the extra income would be used largely for 'one-for-one' replacement.

Although intended to be cost-neutral, in practice higher sales have affected local authority business plans in different ways, for example:

- rules on how Right to Buy receipts are applied allow councils flexibility to decide if they benefit their HRA or their General Fund; many have decided on the latter
- receipts retained for reuse have to be returned to the Treasury if not reused within three years (which has proved to be too tight for many councils with complex development schemes)
- one-for-one replacement has so far proved ineffective,<sup>40</sup> so that stock has declined (there was an overall decline of 3% in HRA stock in the first three years of self-financing)<sup>41</sup>
- cost savings through sales do not cover the losses in rental income
- because purchasing tenants are generally on higher incomes, they are likely to have paid rent regularly.

A further development that could lead to similar rates of stock loss as Right to Buy was announced during the election campaign and is now part of the Housing and Planning Act: requiring councils to sell off 'higher-value' council stock. CIH estimates total sales under this scheme to be likely to fall in the range 2,100-6,800 per annum, but it is difficult to judge the impact until further detail is made available by the government.<sup>42</sup> However, because of the uncertainty there has inevitably been concern among councils, especially those which (under various analyses) are most likely to be affected.

## The HRA ring fence

Because local authority General Fund spending was severely cut in the Spending Review 2010, especially non-HRA housing expenditure,<sup>43</sup> councils have been tempted either to move funds out of the HRA (ie to breach the ring fence) or else to charge extra costs to the HRA that previously were met from their General Funds. The legislation for self-financing left an apparent loophole until October 2013 for funds to be transferred, and a number of councils did so, necessitating a warning from DCLG.<sup>44</sup> In addition, several authorities decided to charge more costs to their HRAs, and in some cases it was not obvious they were for 'landlord services', apparently violating the minister's principle 'who benefits pays' (see chapter 3).

## Rents

The most numerous and significant changes affecting the settlement have been in rents policy:

- **Formula change.** In June 2013, government announced that the rent increase formula would in future be based on CPI (not RPI) inflation, creating some uncertainty as to whether this would result in lower projected rental incomes. It said that '...from 2015/16 social rents will rise by CPI plus 1% each year for 10 years'.<sup>45</sup>

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<sup>40</sup> CIH (2015) *Keeping Pace: Replacing right to buy sales*. Coventry: CIH with NFA and LGA.

<sup>41</sup> Wilcox, S., Perry, J., Stephens, M. and Williams, P. (2016) *UK Housing Review 2016*. Coventry: CIH, Commentary Chapter 4.

<sup>42</sup> Wilcox, S., Perry, J., and Williams, P. (2015) *Selling off the Stock: An interim analysis of the proposals for sales of council houses in high-value areas to finance a new right to buy for housing association tenants*. Coventry: CIH.

<sup>43</sup> Perry, J. (2014) 'Local government cuts: housing services have been hit hardest' in *Guardian Housing Network* (see [www.theguardian.com/housing-network/2014/sep/17/housing-spending-cuts-local-government-welfare](http://www.theguardian.com/housing-network/2014/sep/17/housing-spending-cuts-local-government-welfare)).

<sup>44</sup> See letter from DCLG (Jane Todorovic) to local authorities, dated 26 November 2013.

<sup>45</sup> HM Treasury (2013) *Investing in Britain's Future*, Cm 8669. London: HMT.

■ **End of convergence.** The following month, government said that the new formula (CPI + 1%) would continue to apply from 2015/16 onwards, and that the planned convergence of local authorities with housing association rents would no longer take place. Referring to its ‘commitment to a long-term rent policy’, the statement added: ‘...when we say rent increases of up to CPI + 1% from 2015/16 onwards, that is what we mean’.<sup>46</sup> In October there was a consultation on the change and in May 2014 formal guidance was issued.

■ **Rent reduction.** In July 2015, the Summer Budget announced a further change from 2016/17, in which rents would be reduced by 1% a year for four years resulting in a 12% reduction in average rents by 2020/21. The LGA forecast a cumulative loss of £2.6bn, and commented:

*‘The cost to councils will rise from £234m in year one, to £508m in year two, £795m in year three, and over £1bn by 2019/20. By that point the annual funding gap will represent 60% of local government’s total housing maintenance budget. Over the four years the total £2.6bn will be equivalent to the cost of building almost 19,000 new homes.’*

■ **Pay to stay.** The Summer Budget also announced that pay to stay, in which ‘higher income’ tenants pay up to market rents, will apply on a compulsory basis for local authorities. This has two potential adverse effects on business plans:

- Rather than ‘pay to stay’, it seems likely that many tenants will instead opt for Right to Buy, thus further reducing the stock.
- Local authorities will gain no extra income from pay to stay, as they will be required to pay the extra rental income (minus admin costs) to the Treasury.

## Welfare reform

Welfare reform is having a complex effect on councils’ incomes because as one set of measures works through, another takes over. The cumulative effects are considered in more detail elsewhere,<sup>47</sup> but they include those of the ‘bedroom tax’, the benefits cap, benefits sanctions, discretionary housing payments and (under universal credit) direct payments of benefits to tenants. Benefit rates will also be frozen for four years from 2016/17. Most social landlords are reported to be experiencing higher levels of arrears, and to be projecting higher arrears levels in reassessing their business plans.<sup>48</sup>

## Conclusions

The changes outlined above have all had a detrimental effect on the HRA self-financing settlement, on councils’ 30-year business plans and on their ability to invest. As is readily apparent, some clearly breach assurances given at the time of the settlement (eg rents policy changes), others are completely new factors or ones that have grown in their impact (Right to Buy and welfare reform), and yet others will have impacts but the details are not available to enable them to be fully assessed (high-value sales, pay to stay). Several have already had reported effects on councils’ willingness to invest, especially the 1% rent reduction.<sup>49</sup>

The next chapter assesses the impact based on national modelling of the changes, focussing on the reductions in rents.

<sup>46</sup> See letter from DCLG to ARCH, 2 July 2013 ([www.cih.org/resources/PDF/Policy%20free%20download%20pdfs/What%20you%20need%20to%20know%20about%20rent%20setting.pdf](http://www.cih.org/resources/PDF/Policy%20free%20download%20pdfs/What%20you%20need%20to%20know%20about%20rent%20setting.pdf)).

<sup>47</sup> Wilcox, S., Perry, J., Stephens, M. and Williams, P. (2016) *UK Housing Review 2016*. Coventry: CIH, Contemporary Issues Chapter 2.

<sup>48</sup> ARCH & NFA (2015) *Welfare Reform Survey 2015* (see [www.arch-housing.org.uk/news/latest-news/archnfa-welfare-reform-survey-results.aspx](http://www.arch-housing.org.uk/news/latest-news/archnfa-welfare-reform-survey-results.aspx)).

<sup>49</sup> Barnes, S. (2016) ‘Councils axe building programmes after rents cut’ in *Inside Housing*, 26 February (see [www.insidehousing.co.uk/business/development/councils-axe-build-programmes-after-rent-cut/7014108](http://www.insidehousing.co.uk/business/development/councils-axe-build-programmes-after-rent-cut/7014108)).

# how have the changes affected the HRA nationally?

The introduction of housing revenue account self-financing in 2012 aligned local authority housing debt more closely with the ability to pay, and offered the prospect of councils being able to operate in a more business-like manner. The settlement was based on a range of assumptions for each local authority. These included stock numbers, average rents, costs of management, maintenance, disabled facilities, major repairs, inflation, Right to Buy sales and stock numbers. The settlement projected indicative cashflows from these assumptions over 30 years to calculate a net present value. By taking into account the assumed levels of income and expenditure for each authority, that value provided an indication of the debt that each council could afford, which formed the basis of the debt allocation to each authority.

Since the self-financing settlement a range of changes have impacted on the policy and operating environment for local authorities, outlined in chapter 4. We have remodelled the national HRA settlement, building in updated inflation figures and then revising the outcome to reflect the rent reduction policy, the most significant of the changes in chapter 4 that can be modelled in detail. We have compared the effects of these changes with the original finance settlement model to assess their impact on stock-holding local authorities nationally.

## Changes in assumptions for a revised national HRA model

### Costs and income – inflation assumptions

Real world price increases have varied substantially from the settlement assumptions. The settlement assumed that costs would rise at 3.5% a year for 30 years, with rents increasing at 4% a year. Figure 4 compares the September inflation figures used by local authorities in the first three years after the settlement with the settlement assumption:

**Figure 4: Cost and income assumptions in the settlement and how they have changed**

	2013/14 uplift %	2014/15 uplift %	2015/16 uplift %
<b>Cost increases</b>			
September RPI	2.6%	3.2%	2.3%
Settlement assumption	3.5%	3.5%	3.5%
Difference	-0.9%	-0.3%	-1.2%
<b>Rent increases</b>			
Inflation element	2.6%	3.2%	1.2%
Real-terms increase	0.5%	0.5%	1%
Actual increase	3.1%	3.7%	2.2%
Settlement assumption	4.0%	4.0%	4.0%
Difference	-0.9%	-0.3%	-1.8%

Source: Author calculation (Glenn Smith, CIH Consultancy).

Note: Cost increases are all at RPI. Rent increases in 2012/13 and 2013/14 were based on RPI + ½% (in line with government guidance at the time). The 2015/16 rent increase reflects revised guidance, which linked rent increases to the lower consumer prices index (CPI) + 1%.

The table shows that both the costs of services and the income from rents have been lower than assumed in the settlement. Lower than expected inflation is beneficial, but lower than expected income has an adverse impact.

When the Government announced a switch from rent increases based on RPI + ½% to increases based on CPI + 1%, RPI was ½% higher than CPI. However, by September 2014, which was used for 2015/16 rent increases, the difference had increased to 1.1%. Official projections suggest that the gap will stabilise at 1-1.3%, and CPI has been running at 1% below RPI since November 2015.

The settlement assumed that costs would be around 79% of rents in 2012/13. This means that a 1% increase in both costs and rent produces a net increase in income of 29p for each additional £1 charged as rent. On the other hand, costs have to reduce by £1.27 to compensate for a £1 loss of rent.

It is important to note that any change in the inflation assumption not only impacts on the year in which the assumption applies; it also affects later years. A lower than expected increase in rents in one year also reduces the base level rents for subsequent years. The net impact of the changes in inflation assumptions has been to remove substantial amounts of income throughout the self-financing model.

## Policy decision to reduce rental income

Landlords must reduce social rents by 1% a year for four years in cash terms from 1 April 2016, instead of increasing them by CPI + 1%. This means that a rent that was £100 a week in 2015/16 became a rent of £99 a week in 2016/17, instead of the rent of £100.90 that would have applied under previous guidance. Accordingly, the loss to the self-financing model in 2016/17 is £1.90 per week for each £100 of rent in 2015/16. By the end of the rent reduction period, in March 2020, this gap grows to £12.06 per week for each £100 of rent in 2015/16. This difference continues to increase after the rent reduction period, when we have assumed that CPI + 1% increases would resume, in line with government guidance.

## The modelling approach

We have based all of our calculations on the financial model that was published by DCLG at the time of the HRA self-financing settlement. By modifying the inputs to that model we have been able to re-run the settlement calculations to show what cash flows would have been generated if we had known at the time of the settlement what we know now.

We have modelled two separate scenarios, which incorporate the items we discuss above. They are characterised as follows:

1. Before rent reduction:
  - a. actual September CPI and RPI figures used for rent increases in 2013/14 to 2016/17
  - b. rent increases from 2015/16 are based on CPI + 1% instead of RPI + ½%
  - c. a 1% difference has been assumed between RPI and CPI from 2017/18 (CPI being lower)
  - d. Bank of England forecasts have been used for CPI assumptions in future years
  - e. all other assumptions remain the same.
2. After rent reduction: the same assumptions as in (1) above except:
  - a. a 1% reduction in rents each year from 2016/17 until 2019/20, returning to CPI + 1% rent increases from 2020/21 (in line with government guidance).

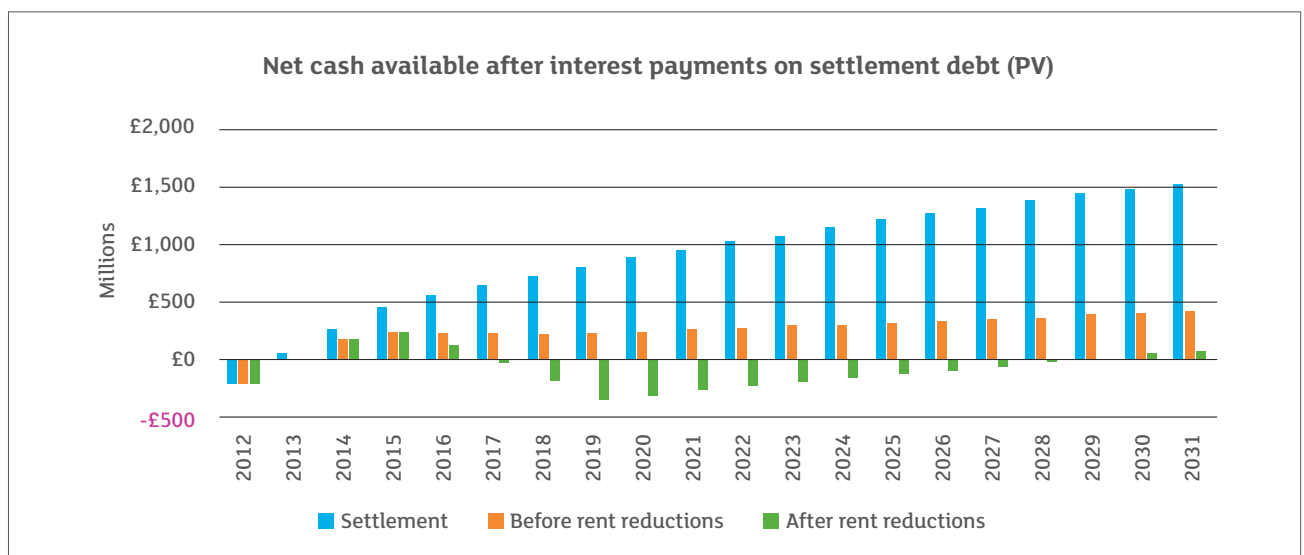
Further changes in the pipeline outlined in chapter 4, such as higher-value sales and pay to stay, have been omitted from the analysis because of lack of detail on how they will operate. However, it is clear that they could have a significant impact on cashflows. In particular, measures relating to higher-value sales have the potential to remove an income-earning asset, but leave the authority with residual debt and operating costs that it must still continue to pay. Unless local authorities are compensated for lost cashflow, these measures could further affect the viability of local authority HRA business plans.

## The results

### Impact on cashflow

Figure 5 summarises the results of the analysis for the scenarios before and after the rent-reduction policy. It shows the net present value of the cashflow available nationally, after paying for interest on the self-financing settlement debt, alongside the same figure that was forecast by the self-financing settlement. Measures implemented before rent-reduction had already reduced the cashflows and after the policy cashflow worsens, becoming negative for about a decade.

**Figure 5: Remodelled national HRA: Net cash available after interest payments before and after rent reduction policy**



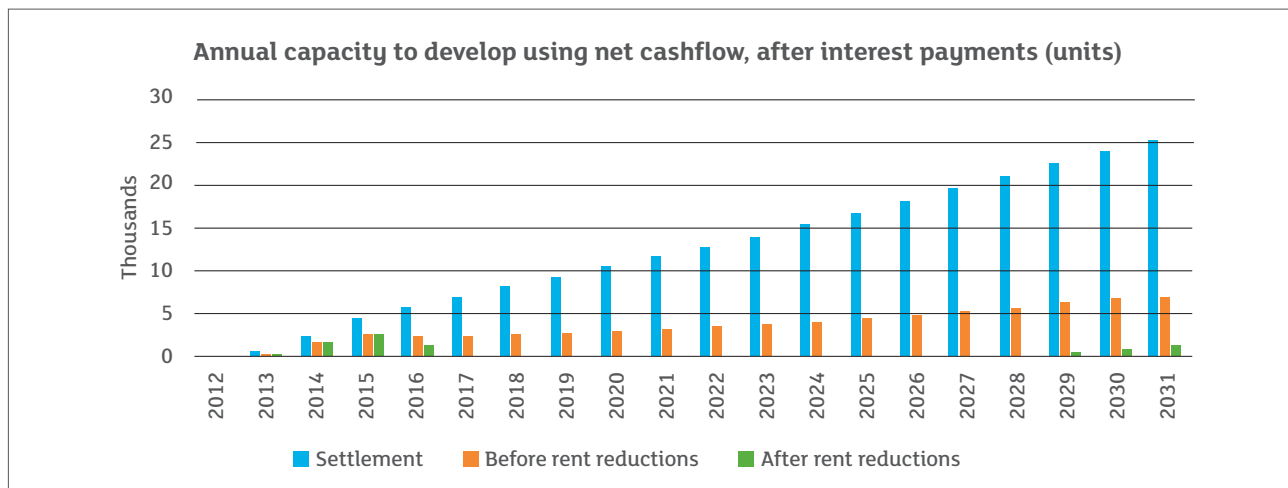
Source: Author calculation (Glenn Smith, CIH Consultancy).

Note: Figures are at net present values (2012).



## Impact on new-build capacity

**Figure 6: Remodelled national HRA: Annual capacity to develop new homes using net cashflows (after interest payments)**



Source: Author calculation (Glenn Smith, CIH Consultancy).

Reduced cashflow means that authorities have significantly lower resources available to them to invest in their stock or to build new homes. Figure 6 shows a simple measure of how many new homes authorities could potentially build with their available cashflow under each scenario, compared with the number they could potentially build under the self-financing settlement.

It is striking that there is no potential capacity for authorities to build new homes between 2017/18 and 2028/29 under the scenario that includes the effects of rent reductions. This occurs because the self-financing model generates insufficient cashflow to repay the self-financing debt between those years, and so there is no additional cash to invest.

## Conclusions

It is clear that the cashflows available to local authorities under the self-financing settlement have dropped dramatically, even before taking into account the requirement for rent reductions and other changes that are expected under the Housing and Planning Act 2016. The original self-financing model showed potential capacity for authorities to build more than 550,000 units over 30 years. After taking into account the effects of inflationary changes, this capacity for building new units reduced to 160,000 (or 28% of the capacity at the time of the settlement).

The effects of rent reduction mean that the capacity to build drops further to just 45,000 units (or 8% of the capacity at the time of the settlement).

Government proposals on higher-value sales are likely to have a further impact on the ability of local authorities to provide housing, unless authorities receive appropriate compensation for any consequential reduction in their cashflows.

# how are the changes affecting HRAs locally?

*‘Self-financing presents a significant opportunity to manage your housing assets locally for the ongoing benefit of local people. Councils and ALMOs up and down the country are working with tenants to make the most of this opportunity thinking about how best to use their assets and to invest in existing and new stock to meet local needs and aspirations and think about the long-term future of their housing stock.’*

Alongside the modelling described in chapter 5, and with the aim of providing detailed examples of effects on the ground, CIH/CIPFA conducted a survey of stock-holding local authorities. The survey was a high-level attempt to see if the optimism of a few years ago (as expressed in the quote above<sup>50</sup>) had been replaced by concern over the financial viability of councils’ HRAs.

The survey was designed to consider the impact of recent policy changes on council housing business plans and was sent to all stock-owning councils with HRAs.

A working group consisting of staff from CIH and CIPFA, with support from members of the CIPFA housing panel, worked on the questions and definitions. A pilot was run with three local authorities and slight changes were made following feedback from the pilot. A copy of the questionnaire, definitions and an explanatory letter were emailed to contacts in every target authority.

## Recognised challenges

The survey was intended to capture a high-level view of the changes in HRA business plans. It was not intended to be a detailed financial analysis and the level of questions reflected this approach. The survey team recognised that there would be two main challenges:

- lack of resources to complete the survey
- lack of detail on the forthcoming policy changes.

### Lack of resources

With the pressures on housing staff at the current time and the changes in policy following the Housing and Planning Act it was recognised that many organisations would struggle to find the resources to complete even this level of survey. To mitigate this, the survey was designed to ensure that the information requested would be readily available and that organisations would not have to collect or analyse any additional data. In addition, the survey was deliberately kept short and used a repetitive format that was easy to complete. Narrative and open questions were kept to a minimum.

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<sup>50</sup> LGA/CIPFA/CIH (2013) *Good Practice Principles to Support the Self-financed Housing Revenue Account*. London: LGA/CIPFA/CIH.

## Lack of policy detail

The questions asked details about the estimated impact that policy changes would have on organisations over the next four years. These policy changes were:

- rent reductions
- sales of higher-value assets
- pay to stay.

Whilst the details of the rent reduction can be modelled on the business plan with a degree of accuracy, it was recognised that the changes in rents for higher-income tenants and sale of higher-value assets would be less easy to model as the detail is still being clarified. The results therefore reflect different assumptions being made but gave respondents the option to explain their assumptions.

*'Our Business Plan does not reflect the potential impact of the void sale levy, but this will be modelled in as soon as it is announced.'*

To mitigate the risks around the responses the survey results have been presented as an identified trend or pattern rather than specific financial or unit data.

## Responses received

Focused follow up calls ensured that the responses included a comprehensive cross-section of HRA local authorities to mitigate lower response numbers and replies were received from a mix of:

- London councils
- unitaries and districts
- urban and rural authorities.

For the reasons noted above we expected and received a limited response – from 31 local authorities in total – but nevertheless they were balanced in the ways noted above and gave a comprehensive geographical spread of local authorities across England.

## Overall summary

The survey confirms that those authorities with housing stock see considerable challenges over the next four years. There are clear concerns over the reduction in rental income and these can be seen in reforecast business plans and warnings over financial stability.

The survey also highlights how the lack of information on the new policies has impacted very differently on mid-term financial planning by different authorities. While some have modelled all new scenarios even though many details are still lacking, others are taking a more cautious approach, waiting for details to emerge before recalibrating their plans.

Overall the financial uncertainty already appears to have affected the ability to build homes. For some this may lead to seeking alternative approaches such as the creation of housing companies that operate outside the HRA; but for many the reduction in rent and the erosion of assets have meant the reduction or abandonment of any growth ambitions.

## Rental income

Rental income was perhaps the easiest factor to map as part of the survey as the reduction in rent was clearly defined. The question considered the gross rental income both before and after the introduction of the rent reduction. The rental income is used to support the delivery of the service and pay off debt and therefore a reduction in this income stream results in difficulties for long-term planning.

*'Lower than anticipated revenue projections due to recent policy changes, making it almost impossible to service any additional borrowing costs; along with general uncertainty in the social housing sector on future policy changes making it difficult to plan for the future.'*

The questionnaire considered a comparison of expected rental income in the original business plan and the expected rental income after the changes in policy. A comparison of the figures being predicted for 2019/20 showed a drop in expected rental income in line with the modelling in chapter 5.

Some of the responses talked about assumptions they were making beyond our survey with one respondent saying:

*'The immediate impact of the 1% rent reduction is £6m over four years and expected to be £86m over 30 years.'*

## Bad debt and arrears

The data around bad debt provisions and arrears suggested a mixed response and many were waiting on greater detail before amending their approach. For those that had responded to policy changes in this area they had also been influenced by the introduction of universal credit. In these instances we saw rises in provisions for bad debt. For example:

*'Original 2012, 0.9% bad debt provision. Now 2015/16 and 2016/17, 1.5% then increase to 2.5% thereafter. In future years we have allowed an increase in provisions to cover the introduction of universal credit/welfare reforms.'*

*'Bad debts rise from 0.8% to 3% from 2017/18.'*

## Repairs and maintenance

Authorities' initial budget forecasts for repairs and maintenance in 2017/18 were compared with current forecasts and suggested an overall downward trend of approximately 3%, but adjustments in this budget are not solely linked with government policy changes:

*'Repairs and maintenance contract was renegotiated in 2014/15 and a saving was identified. The adjusted budgets therefore represent this new contract rather than any impact from government policy.'*

In addition not all organisations were reducing their budgets in this area and data identified that some organisations had not made any changes to their budgets while others intended to increase spend in this area:

*'We are spending more on repairs and maintenance as we have introduced a new way of working following systems thinking approach to our work.'*

## Surpluses

The two largest respondents in terms of housing stock both said that there would not be any surplus in years 2015 – 2019. All other respondents except one identified a reduction in surplus over the next four years with almost half moving into a deficit position by 2017/18.

The reasons behind these profiles varied but many of the narrative comments included policy changes, for example:

*'The profile of surpluses is linked to the debt repayment profile, which is dealt with by building up a repayment reserve. Surpluses continue to fall away in later years as property numbers decline following the policy changes further promoting Right to Buy since 2012.'*

The one respondent with an increased surplus identified other reasons not related to policy changes.

## Reserves

Reflecting the overall trends from the survey a comparison of reserves saw the cumulative amount of reserves reduce from the pre-policy forecast:

*'Reserves set at 3.75% of rent account from 2017/18. Difference between business plan and forecast is reflective of the policy change.'*

However, the picture was not a simple one, and as a number of factors influenced the reserve figures it was difficult to extrapolate the information. For example:

*'In the current business plan reserves are only being maintained because we are assuming maturing PWLB loans will be refinanced rather than repaid.'*

## New build

Looking to the future there was still a desire to build homes although how this was to be accomplished was very challenging. Some 21% of respondents said they were building outside the HRA. One council who had completed 107 new units in 2015/16 was now having to rethink their strategy in light of changes and stated:

*'We had originally planned to build/provide approximately 60 new homes, but due to policy changes we have now reversed this decision and plan to now build these through a housing company.'*

Others were able to continue in the short term but in the longer term they had less confidence:

*'Will still fund existing planned schemes but new provision beyond 2019/20 subject to review.'*

A snapshot view of homes built in 2015/16 compared with numbers expected to be built in 2019/20 shows a decline of around a half within just four years.

# conclusions and recommendations

This chapter sets out the conclusions reached from revisiting the history of the self-financing settlement and its aftermath (chapters 1-4), the overall modelling of the national HRA (chapter 5) and the survey of local authorities (chapter 6). It then makes recommendations for action.

## Conclusions

### What promises were made about self-financing of council housing?

The coalition government made a number of promises about the self-financing of council housing in the period before April 2012, in part to convince local authorities to accept the deal. In the words of the then Housing Minister, Grant Shapps, it was ‘a reform intended to endure for the long term’. The government said that there would be ‘a further adjustment to the debt allocated to local authorities if a future policy change has a significant material effect on their costs or income’ and that the measure was ‘designed to protect both councils and the Exchequer’. The government was also committed ‘to assessing over the long term the impact of policy changes that may affect landlord income and the case to make good any losses or address any gains’.

Such reassurances paved the way for a trouble-free transition at the end of March 2012 in which all stock-holding local authorities adjusted their debt levels (in most cases, upwards) in compliance with the Treasury’s directions. As a result, the Treasury received gross payments totalling some £13bn, the costs of which must be borne from councils’ current and future rental income.

Councils understood that as a result of the self-financing settlement they were taking on additional risks. Because the majority took on extra debt, the sustainability of their HRA income to service that debt was crucial. As the settlement promised, they would for the first time be able to make and adopt robust 30-year business plans, but these plans would only stay robust if HRA income could reliably be forecast and (within certain tolerances) maintained at the forecast levels. This would allow debt costs to be met and the value of the assets (the housing stock) and the quality of the housing management service to be maintained. Unexpected and significant loss of income, of assets or of the ability to maintain service levels could all prejudice the viability of the settlement.

### What mechanisms were put in place to ensure the promises were made good?

Given subsequent developments, it is now rather surprising to note that the settlement was essentially made ‘in good faith’ on the part of local authorities. Although legislative provision for the settlement was made in the Localism Act 2011, the power to make changes to it rests solely with the Secretary of State, and offers no redress to local authorities if they believe changes are required but the government declines to act. Section 169 allows for further payments to be made (either to or from HM Treasury) if there is a ‘change in any matter’ taken into account in the settlement. But it can only be invoked by the Secretary of State (although any new determinations must be subject to consultation with local authorities and professional bodies). Therefore not only would the government have to acknowledge that a policy change ‘has a significant material effect on [local authorities’] costs or income,’ but it would also have to be willing to take action.

One reason for the one-sided nature of the bargain is of course because it is government which writes legislation. A second is that (as we saw in chapter 3) the coalition decided to impose a settlement rather than pursue the negotiating strategy used by the Labour government. Government would also argue that it had consulted extensively on the mechanisms of the settlement. With hindsight, it is apparent that local authorities' concerns at the time (to which the minister responded as noted above), that the government might subsequently demand extra payments in addition to those made on 1 April 2012, did not correctly anticipate the problems that would soon emerge. These were not additional payment demands by the Government but a sequence of decisions that would progressively erode local authorities' rental income, needed to make the payments already agreed (and of course to finance any new investment).

## Were the self-financing promises kept?

In one sense the government would argue that it has left the 2012 settlement intact, in that it has not called for extra payments from local authorities, nor has it changed the borrowing caps that were set at the time. It has in fact not used any of the discretionary powers given to it by Part 7, Chapter 3 of the Localism Act, to vary the settlement.

However it is clear from chapter 4 of this report that the government has in practice taken a series of decisions which undermined the settlement. In summary, they are:

- **Rent levels have had to be reduced to substantially below expected levels.** A series of decisions – the change from RPI to CPI uprating, the end of rent convergence and the four-year rent freeze from April 2016 – have together led to a substantial reduction in forecast rental income.
- **Assets are being sold more quickly than anticipated.** The 'reinvigorated' Right to Buy began at the same time as the settlement and has significantly increased sales. To this effect must be added the enforced sales of higher-value stock, details still unknown, and the effect of 'pay to stay' in further promoting Right to Buy sales without producing any increase in local authority rental incomes. While councils receive some compensation for additional Right to Buy sales in recognition of reduced cashflow, they remain responsible for the debt on the units sold.
- **Welfare reform makes it harder to collect rents.** More tenants now have payment difficulties and numbers are likely to increase sharply as universal credit is implemented. Collection costs are therefore higher and more income is lost through bad debts.

## What has been the effect on the settlement and on local authority business plans and on investment?

It is clear from our modelling exercise (see chapter 5) that the cashflows available to local authorities under self-financing have already dropped dramatically, even before taking into account the requirement for rent reductions and other changes highlighted in this report. The original self-financing model showed potential capacity for authorities to build more than 550,000 units over 30 years. Taking into account the effects of inflationary changes, this capacity for building new units has already reduced to 160,000 (or 28% of the capacity at the time of the settlement).

The effects of rent reduction mean that the capacity to build drops further to just 45,000 units over 30 years (or just 8% of the capacity at the time of the settlement). This is no higher than levels currently being achieved. Government proposals on higher-value sales are likely to have a further impact on the ability of local authorities to provide housing, unless authorities receive appropriate compensation for any consequential reduction in their cashflows.

The survey of local authorities (chapter 6) confirms that those with housing stock see considerable challenges over the next four years. There are clear concerns over the reduction in rental income and these can be seen in reforecast business plans and warnings over financial stability.

The survey also highlights how the lack of information on the new polices has impacted very differently on mid-term financial planning by different authorities. While some have modelled all new scenarios even though many details are still lacking, others are taking a more cautious approach, waiting for details to emerge before recalibrating their plans.

Overall the financial uncertainty already appears to have affected the ability to build homes. For some this may lead to seeking alternative approaches such as the creation of housing companies that operate outside the HRA; but for many the reduction in rent and the erosion of assets have meant the reduction or abandonment of any growth ambitions.

## Summary

The survey, accompanied by the modelling, provide conclusive evidence that the April 2012 settlement has been undermined by government policy changes since, that have sharply reduced HRA incomes and the ability to invest in the existing and in new housing stock. If the legislative provisions had allowed for a reassessment of the settlement to be triggered by either central or local government, then the latter would have a compelling case to require the settlement to be revisited. As it is, while local authorities can take limited protective action to maintain the viability of their HRAs by avoiding new borrowing (and hence cutting back on their investment plans) and by making revenue savings which inevitably affect service levels, only central government can restore the viability of the overall settlement.

## Recommendations

The recommendations below stem from the conclusions and are intended primarily to help local authorities to restore their investment plans to at least the levels available to them at the time of the settlement.

### Recommendations to government

1. That the Department of Communities and Local Government reviews policy changes which have had 'a significant material effect on [local authorities'] costs or income' and considers mitigating those policy changes.
2. That such a review considers ways in which the investment potential of local authorities can be restored so that their business plans can once again be put on a sustainable basis and local authorities can play a full role in delivering housing supply.
3. In response to these findings, that it specifically considers:
  - a. Reviewing the remaining three years of the four-year reduction in HRA rents and replacing it with a less drastic requirement.
  - b. Allowing local authorities to retain the full extra income from the 'pay to stay' scheme.
  - c. Reviewing the effects of the next stages of welfare reform on HRA incomes, and in particular considering measures that would mitigate the impact of universal credit such as payments direct to landlords and twice-monthly payments (as already agreed for Northern Ireland).
4. That in relation to higher-value sales, the Government considers how best to fully compensate each authority's business plan, by either:
  - a. allowing them to reinvest the receipt to generate a replacement income stream, or
  - b. letting them deduct the present value of residual costs from the sale receipt, or
  - c. permitting them to redeem debt, or
  - d. a combination of these.



5. That Government considers offering stock-holding councils a refreshed 'deal' including the points made here and, where necessary, some flexibility in borrowing caps, in return for specific commitments on new supply, including better use of assets and of local authority-owned land.
6. That Government reiterates the earlier commitment to long-term sustainable business plans and agrees to judge future policy changes against this objective, including those relating to welfare reform.

### **Recommendations to stock-holding local authorities**

1. That they urgently review their HRA business plans if they have not yet done so, taking into account the full range of factors covered in this report.
2. That local authorities consider (through the Local Government Association (LGA), Association of Retained Council Housing (ARCH) and the National Federation of ALMOs (NFA)) what 'offer' could be made to government to improve housing supply in return for commitments that would provide more stable HRA business plans.



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