# London Borough of Barnet

## Loaning to a Registered Provider Report

December 2015

31tenconsulting.co.uk

# Contents

# Executive Summary

The London Borough of Barnet (the Council) commissioned 31ten Consulting Limited (31ten) in September 2015 to support it in developing an approach to providing funding to a new Registered Provider (RP) subsidiary to Barnet Homes, Open Door, for the development of 320 to 500, two and three bed affordable rent units. Barnet Homes is the Council's Housing ALMO and part of The Barnet group (TBG).

The Council's Housing Strategy has the overarching objective of providing housing choices that meet the needs and aspirations of Barnet residents and its first priority is to increase housing supply. The new 10 year Management Agreement between the Council and Barnet Homes has a target for Barnet Homes to develop 500 new homes on HRA land to support this priority. The purpose of the proposed loan arrangements is to enable Barnet Homes, through their new RP subsidiary to meet this target.

The delivery of these homes through the proposed loan arrangement has the potential to deliver significant community benefits and reduce the Council's costs on temporary accommodation, whilst at the same time providing a revenue generation opportunity for the Council to balance the risk of providing the funding.

### Scope of the Review

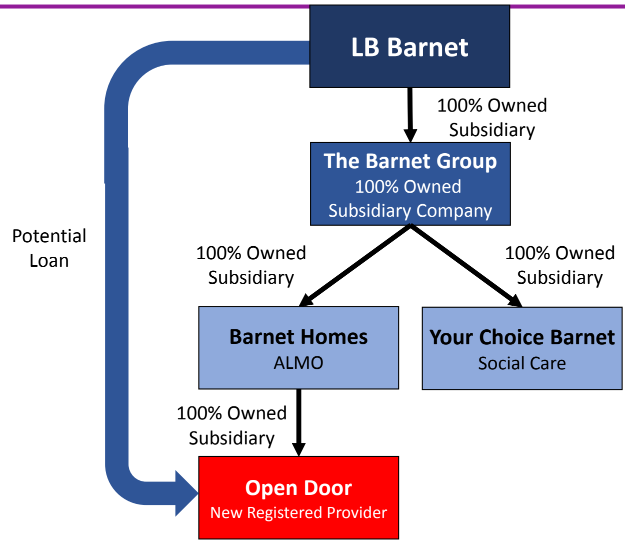
The Council requires specific advice to support it in assessing the proposed funding rate for the facility and terms to be used. In providing advice on this funding rate the Council also requires support in considering the impact of this rate on the potential viability of the development and proposals as to how to account for and mitigate risk of the transaction within the Council's accounts.

### Understanding of the structure of the new RP

Barnet Homes has submitted an application to the Homes and Communities Agency (HCA) to establish a new RP, Open Door, as a subsidiary. The new organisation would undertake the delivery of an initial 320 new homes for affordable rent. The approval of any loans to the Barnet Homes RP subsidiary is, therefore, subject to a successful application. The new development is to be funded through 2 major sources:

- GLA Grant totalling £2.46m which would contribute to elements of the 101 homes; and
- Loan funding from the Council on commercial terms for the full 320 homes to Open Door (with a possible further loan in the future to support the development of an additional 180).

The diagram below details how the new RP fits into the existing structure of the Council's Trading Company and the potential loan that is under review.




The financial modelling review was undertaken utilising two recognised industry modelling tools.

### Review of the interest Rate Used

31ten, in partnership with Arlingclose[1] has undertaken a review of the terms of the loan suggested in the model. The Council is considering a loan of approximately £57m to £65m to Open Door for approximately 35 to 40 years. The loan will have a fixed rate.

The interest rate assessment has been undertaken by reviewing three separate factors, as follows.

- An assessment of Barnet Council's cost of funding plus a suitable credit risk margin
- Minimum requirements under State Aid rules (this has been used as a useful guide to indicate a market rate, although if the loan is solely for affordable use it is not necessarily applicable); and
- An assessment of the rate that Open Door could achieve elsewhere in the market.

This review concluded that the loan rate could be set between **4.56%** (being an appropriate marginal mark up on the Council's cost of funds) and **5.80%** being the appropriate market rate available.

### Benchmarking against other Authorities

It is important to consider the precedents for the Council providing funding to the new RP. A variety of local authorities who have undertaken this role across the Country were therefore consulted. The review team also brought to bear its knowledge and experience from reviewing similar arrangements. This resulted in a series of key findings which are summarised within the report and listed below.

- The importance of risk management workshops
- Recommendations around the strength of the governance process
- The move away from charging Commitment Fees
- Managing risk through variance of loan covenants
- Obtaining an independent View on the Interest Rate to be used

[1] Arlingclose is a Treasury Management advisor who are authorised and regulated by the Financial Conduct Authority (FCA). Its role for this engagement has been to provide FCA guidance and sign off of the Interest Rate to be used in light of the review undertaken. the

- Variance in loan arrangements
- Applying the "Wednesbury Principle" - The principle of acting "reasonably and properly in law"

**Financial Modelling Results**

The findings in the main body of the report are presented in the following way:

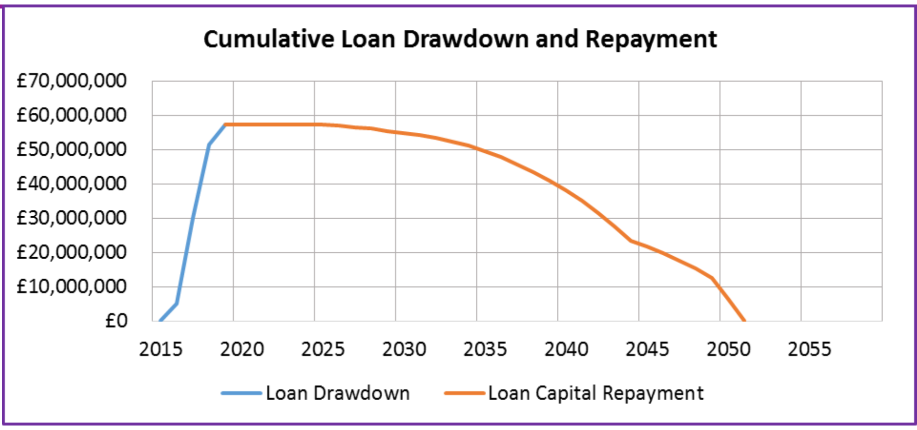
- **Varying Interest Rate** – Because the rate recommended has been set as a range between 4.56% and 5.80% three versions of the baseline scheme are presented to show the impact of this variation – 4.56% 5.02% and 5.80%
- **Varying the build cost** – In order to demonstrate the sensitivity of the build cost the baseline scheme at 4.56% is shown with a plus or minus 5% and 10% build cost to show this impact.
- **Up front funding within the HRA** – The Council has examined the potential to incur some of the costs within the HRA in advance of transferred the land to Open Door. In this circumstance these costs would be incurred by the Council and paid back from "super profits" at the end of the scheme. This option was discounted because it was found the loan was viable without it and the investment did not represent value for money to the Council.
- **£2000 per unit per annum contribution** – A baseline assumption within the model is also a cost to the RP of £2,000 per unit per annum. This is a premium that is to be paid to the Council for each unit, once completed, as agreed between the two parties through the new Management Agreement.

**Outcome from the Review – Proposed loan arrangement**

A proposed 4.56% loan rate produces the following results

| | |
|---|---|
| Development Cost | 52,512,000 |
| Company Operational Cost | 1,551,000 |
| Capitalised Interest & Arrangement Fee | 4,848,000 |
| Net Rental Income | -2,854,000 |
| Required Working Capital Reserve at end of Dev. | 1,398,000 |
| Council HRA Funding | 0 |
| **Total Loan Facility** | **57,454,000** |
| **Blended Interest Rate** | **4.56%** |
| **Interest Only Period (Years)*** | **4** |
| **Payoff Period (Years)*** | **32** |

This demonstrates that a total loan of £57.5m is required. This is then paid back over 32 years with interest only being paid over the first 4 years and then any excess cash being used over a £1m float to pay down principal over the life of the loan. This is exemplified in the graph below.




A loan rate of 4.56% is considered prudent for the following reasons

- As Barnet Homes / TBG are wholly owned by the Council the risk of the loan is reduced
- It ensures that the loan can be repaid within 35 years – a period that an external lending organisation would find acceptable (and taking account a potential 5% increase in build costs as modelled in the sensitivity analysis)
- It meets Council's aspirations to achieve a 1.25% margin on the loan, which is in line with other local authorities who have provided similar loan arrangements
- The rate needs to be sufficiently attractive to encourage and give confidence to TBG Board to develop more homes for affordable rent

The table below shows the three different interest rates for comparison purposes

| | 4.56% | 5.02% | 5.30% |
|---|---|---|---|
| Total Loan Facility | £57.5m | £60.4m | £65.6m |
| Interest Only Period | 4 years | 8 years | 14 years |
| Payback Period | 32 years | 36 years | 40 years |

### Key Sensitivity Results

Clearly there are risks, both upside and downside, to each of the core assumptions. The most likely of these to effect the scheme are those in relation to build costs and phasing. Using the baseline 4.56% loan rate,the tables below show the impact on the level of loan required and the payback period for the debt by varying the build cost and phasing assumptions respectively.

**Build Cost Variation**

| Build Cost Variation | Value of Loan | Payback period |
|---|---|---|
| -10% | 50,629,000 | 27 |
| -5% | 53,930,000 | 31 |
| 0 | 57,454,000 | 32 |
| +5% | 61,326,000 | 34 |
| +10% | 65,614,000 | 37 |

**Phasing Variation**

| Scheme Delay Variation | Value of Loan | Payback Period |
|---|---|---|
| Core scheme | 57.5 | 32 |
| 2 month delay | 58.2 | 33 |
| 4 month delay | 59.0 | 33 |
| 6 month delay | 60.1 | 34 |

Due to the fluid nature of housing development it is suggested that some flexibility is built in to the loan arrangement, as a contingency, to allow for some possible variation as outlined above.

## Impact on the Council

In order to judge deliverability it is important to model the impact of the loan on the Council's accounts.

The key impacts to the Council revenue account are as follows:

- The margin on the loan is made above the Council's cost of funds
- £2,000 per unit per annum payment from the RP as agreed in the Management Agreement
- Arrangement fee@ 1% of loan
- Mismatch in interest incurred vs received in the development period

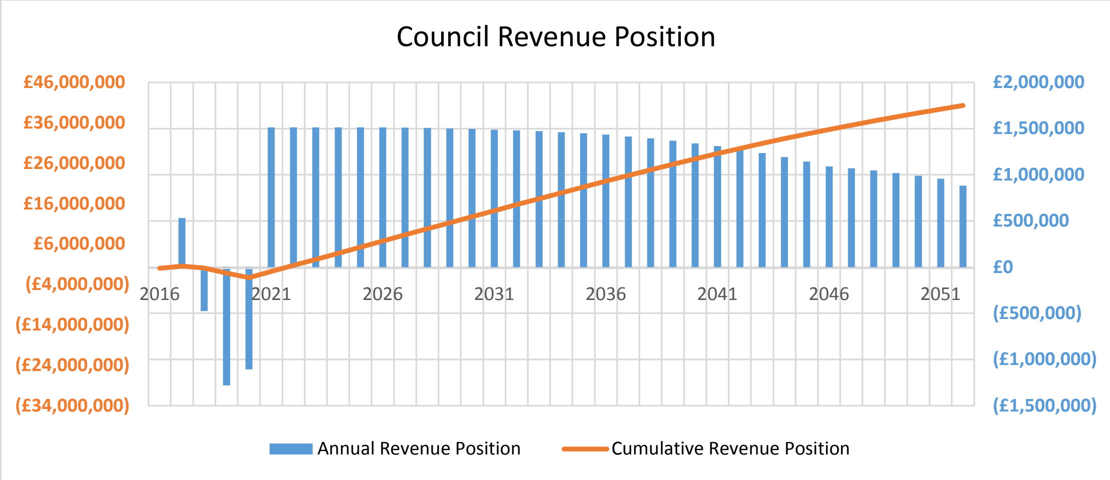
The table below shows the potential net income receivable over the life of the loan assuming the following loan arrangements:

- Council cost of funds - 3.32%;
- Loan to Open Door at 4.56%
- Interest only payments for the first 4 years;
- Loan repaid over 32 years.

The table shows the total net income receivable for each element and the Net Present Value (NPV) of these income streams.

| Council Revenue | | |
|---|---|---|
| **Revenue Type** | **NPV (6.09%)** | **Gross Amount** |
| **Interest Margin** | 6,300,000 | 19,230,000 |
| **LBB £2k Payments** | 7,040,000 | 20,480,000 |
| **Arrang. Fee** | 570,000 | |

This demonstrates a total net income to the Council over the life of the project of £40.2m which has an NPV of £13.9m. The most significant impacts however are in the timing of these effects on the revenue account. This is demonstrated in the graph below.




The graph shows that the Council achieve significant rewards over the life of the project However, assuming the Council borrowed at 3.32% to fund the loan it would incur unmatched costs to the revenue account in years 2-4 of between £0.4m and £1.2m that it would need to fund.

## Summary

This report proposes an appropriate loan rate of 4.56%, which can be repaid over 32 years, assuming approval is granted by the HCA for the creation of Barnet Homes, RP subsidiary, Open Door. However, the Council may want to allow Open Door some contingency to provide for variation in build costs or phasing.

The impact on the Council of making such a loan is significant. It realises substantial returns on the arrangement over the life of the loan, however, there are potential costs to the revenue account in the early years that need to be mitigated through its treasury management arrangements.

The Council need to develop robust legal documentation around this potential facility, including a loan agreement that clearly delineates the new RP from its parent body and the Council, to ensure clarity over where the liability is held for the borrowing, the level of parent company support and the appropriate covenants, step in rights and default provisions.

# 1. Background and Introduction

1.1 The London Borough of Barnet (the Council) commissioned 31ten Consulting Limited (31ten) in September 2015 to support it in developing an approach to providing funding to a new Registered Provider (RP) subsidiary to Barnet Homes, Open Door, for the development of 320 to 500, 2 and 3 bed affordable rent units.

### Scope of the Review

1.2 The Council is assessing the potential to provide funding on appropriate terms to Open Door, the new RP subsidiary of Barnet Homes for the delivery of 320 to 500, 2 and 3 bed affordable rent units and requires specific advice to support it in assessing the proposed funding rate for the facility and terms to be used. In providing advice on this funding rate the Council also requires support in considering the impact of this rate on the potential viability of the development and proposals as to how to account for and mitigate risk of the transaction within the Council's accounts.

1.3 Barnet Homes has provided a series of detailed financial models of the development and this information will principally provide the financial assumptions and information that will form the basis of the advice given in this report.

1.4 The Council has requested specific advice on the following key issues:

**The Nature and Potential Rate of the Loan**

- How should the Council determine the appropriate interest rate that should be used to loan to the new body considering the requirements of state aid / market assessment and how this would be reviewed through the course of the loan period?
- The treatment of the loan within the Council's accounts – both its classification within the balance sheet and the provisions for repayment, including impacts on MRP policy;
- Advise on the potential repayment methods and developing a preferred option for this repayment with the Council;
- Benchmark the approach, scale and rates used against a sample of other local authorities provided by the Council; and
- Consideration the treatment of any preliminary works prior to Barnet Homes establishing the RP.

**The Risk Profile of the Loan to the RP**

- Based on the development appraisal, what is the risk to the RP with regards the potential repayment of the loan(s);
- Examine the interplay between the recommended loan rate and the viability of the scheme;
- Provide high level due diligence on the key assumptions and the assessment of the inflation assumptions within the financial model provided by Barnet Homes.

**Recommended Loan Rate**

- Advise the Council on the appropriate rate to lend to the RP; and
- Provide independent FCA regulated advice through Arlingclose on the appropriateness of this rate.

## Methodology and Approach

1.5 31ten has adopted the following approach in order to complete the work requested by the Council:

### Information Gathering and Review

1.6 31ten undertook an information gathering process to ensure all relevant background material was used to develop an understanding of the scheme. This included the following:

- Interviews with key personnel;
- Review of financial modelling undertaken by Barnet Homes and the assumptions underpinning this;
- Review of the shareholders agreement for The Barnet Group and the proposed structure / governance processes for Barnet Homes and the new RP subsidiary
- Review of guidance pertaining to the use of the EU Reference rate to set loan rates;
- Engagement with Arlingclose in setting the appropriate rate and terms of the loan; and
- Review of current housing and local government finance policy and regulations.

### Development of Bespoke Financial Model

1.7 As detailed within 31ten's proposal a new bespoke financial model utilising the key assumptions has been developed based on the financial information provided by Barnet Homes. This model has been be used to assess the following key tasks:

- To challenge the assumptions within the Barnet Homes modelling, including the work undertaken by Campbell Tickel, and to ensure the innate viability of the scheme has been assessed in a technically correct manner;
- To examine the approach to lending of Council funds and how these will be repaid. The model enables the Council to examine a variety of draw down and repayment methods that include amortised, equal instalment payment and maturity ; and
- The model has been used to examine a variety of sensitivities and scenarios to demonstrate the impact of key risks on the development and the ability of the new RP to repay the loan. Through this process a risk adjusted loan profile has been developed.

### Review / Setting of Assumptions

1.8 In order to review the assumptions there are a variety of steps that have been taken:

- **Core Appraisal Assumptions** – within the modelling undertaken by Barnet Homes and Campbell Tickel the RP has assumed a variety of costs and incomes. Using industry standards and 31ten and Arlingclose expertise a high level review has been undertaken of these assumptions to ensure they are appropriate. This included, but was not limited to: build costs, professional fees, other costs, rental income, loan repayments, carrying balances and delivery phasing.
- **Interest Rate** – The interest rate associated with any loan from the Council has been tested through engagement with Arlingclose by examining the potential rate using three methodologies:
  - Margin on the Council's funding cost;

- State Aid guidance; and
- Review of Alternative Lenders.

- **Banking fees –** Review of the banking fees included within the financial modelling to ensure they represent a commercial approach;
- **Repayment approach and terms –** The architecture of the loan and its repayments, including interest only periods and principal repayment programmes; and
- **Delivery and Repayment Programme** – Review of the delivery phasing and repayment profile for the debt to ensure it is affordable and in line with commercial expectations and review of the Council's MRP policy to ensure it is appropriate for the potential loan agreement

1.9 The output of this process formed a revised set of core assumptions that were used for the scheme.

### Benchmarking against other Authorities

1.10 In order to ensure the outputs of the process above were appropriate they were reviewed against a series of similar Local Authority based lending schemes. Through this process the assumptions above were reviewed and compared, and any differences explained. The Council provided a list of Authorities that were used for this benchmarking that is included at Appendix A.

### Financial Modelling Results

1.11 Based on the above analysis the revised scheme was modelled and a variety of loan arrangements tested. On the basis of the results of this exercise a revised loan arrangement was developed.

### Sensitivity / Scenario analysis

1.12 It is crucial, as lender that the Council not only judge the risk profile of the body being lent to, but also of the scheme being delivered. The process set out so far has addressed the core assumptions and their appropriateness, however, it is vital that the sensitivity of these assumptions is reviewed.

1.13 If build cost increases of 5-10% this could cause the scheme to become fundamentally unviable this additional review should be established and this quantification of risk factored in to this assessment. 31ten working with the Council developed a series of key variable assumptions to consider their impact on the scheme. I

1.14 These sensitivities were then collected into some key scenarios to show downside and upside risk scenarios and their impact on the ability of the new RP to meet the conditions of the loan arrangements.

### Finalisation of preferred loan Approach

1.15 Following the above process the loan arrangements were optimised, including further analysis of the core assumptions, timing, loan arrangements and phasing. This resulted in the development of a preferred scheme that could then be reviewed to finalise the recommended Interest Rate and terms. Arlngclose then undertook a further review of the loan arrangements to recommend the final rate included within this report.

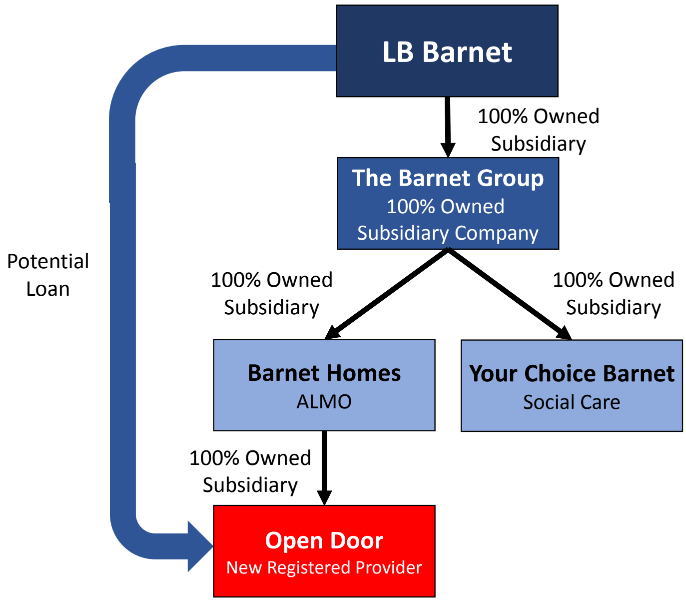
### Conclusions

1.16 Following completion of the tasks above a series of conclusions were drawn in order to provide an evidence base to the Council from which the appropriate loan arrangements can be determined.

# 2. Findings

## Understanding of the structure of the new RP

2.1 Barnet Homes has taken the decision to establish a new RP as a subsidiary to the ALMO. This new body would be the body who would undertake the delivery of an initial 320 new homes under review. There is also the potential of the RP undertaking the development of a further 180 units, bringing the initial potential units to 500. The funding arrangements of this additional 180 units are not currently under review. The diagram below details how the new RP fits into the existing structure of the Council's Trading Company and the potential loan that is under review.




2.2 The Council is reviewing the potential of loaning to Open Door, the newly established RP. The loan agreement would be with this new RP body who would be entirely liable for the debt, rather than Barnet Homes.

2.3 The new development is to be funded through 2 major sources:

- GLA Grant totalling £2.46m which would contribute to elements of the 101 homes; and
- Loan funding from the Council on commercial terms for the full 320 homes to Open Door.

## Review of the Barnet Homes Modelling

2.4 The financial modelling review was undertaken in three stages, as follows:

- Review of Barnet Homes initial in-house modelling using PodPlan;
- Review of Barnet Homes updated modelling using PodPlan; and
- Review of Campbell Tickel modelling, undertaken for Barnet Homes, using Brixx.

2.5 A review of the models showed that they were generally fit for purpose, however, there were a number of issues within them that needed to be addressed in moving to the final bespoke model that forms the underpinning financial appraisal for the loan. These issues / changes in assumptions have been reported in detail in interim reports and agreed between the parties.

## Review of the interest Rate

2.6 Arlingclose[2] has undertaken a review of the terms of the loan suggested in the model. This section summarises Arlingclose's findings. The loan is characterised as follows.

- The loan will finance the development phase of the projects, before amortising once the operational phase begins.
- The loan will be drawn down in stages to meet development expenditure.
- The size of the loan is dependent on the cost of the development.

2.7 This section considers the interest rate on the loan.

### Assumptions

2.8 The key assumptions that underpin Arlingclose's analysis are as follows:

- The development is a commercial undertaking. The management team at Open Door (and Barnet Homes) have experience of successfully delivering similar projects;
- The business model is viable and has been tested extensively;
- Barnet Council is the ultimate parent, has an interest in the development and is able to exert some control over Barnet Group, including Open Door;
- Open Door is a registered provider, regulated by the Homes & Communities Agency;
- Open Door currently has no operational business or cash flows. Land will be transferred by Barnet Council to Open Door to facilitate the development;
- No interest payments are made on the during the development phase. The interest (and the arrangement fee) is capitalised. The loan amortises during the operational phase in line with surplus net income from Open Door; and
- The loan will be secured on all developed properties in whatever state of completion. Both properties and work in progress will be able to be sold be at least 50% of the loan value – loss on default is therefore 50%.

### Interest Rate and Fees

2.9 Barnet Council is considering making a substantial loan of approximately £57m to £65m to Open Door for approximately 35 to 40 years. As before). The exact size and term of the facility is determined by the business/cash flow model detailed below. The loan will have a fixed rate.

2.10 The minimum interest rate that should be charged on the loan will be the higher of the Barnet Council's cost of funding plus a suitable credit risk margin. The maximum rate chargeable will be the rate that Open Door could achieve elsewhere. Once these have been determined, the Council can assess the options and set a rate appropriately.

[2] Arlingclose is authorised and regulated by the Financial Conduct Authority Confidential - not for disclosure to third parties

### Council's Funding Costs

2.11 The majority of local authorities' long-term borrowing is sourced from the Public Works Loan Board (PWLB). Although the Council may opt not to borrow from the PWLB, as it could potentially borrow at lower rates from banks or other local authorities, PWLB interest rates provide a sound benchmark.

2.12 On 4th December 2015, the PWLB new maturity loan rate, including the certainty rate discount to which the Council is entitled, was **3.44%** for 30 years. Given the uncertain repayment profile, a bullet repayment rate over the average life has been used as a proxy for the facility. Note that these rates change daily in line with the gilt market.

2.13 Lenders typically set interest rates at a margin above their funding costs to cover the risk of the borrower being unable to repay the principal and interest as they become due.

2.14 As a new company, Open Door does not have any financial metrics or business history with which an estimate of credit strength can be made. However, its ultimate parent is Barnet Council, which is likely to mean that the Council has or can take effective control of the company. It is also assumed that Barnet Homes, the direct parent of Open Door, has significant development experience given its management of the Council's 15,000 housing stock.

2.15 Given the effective control and an experienced development team, the risk to the Council is lower than it would be given if the borrower was an independent company. The credit risk margin is therefore lower.

2.16 The loan is also secured on the properties being built. Given the development appears to be a Council objective, in the event of Open Door default the Council could simply take ownership of whatever assets there were and incorporate them into its own housing stock, continuing the development. Alternatively, the Council could sell the assets to another developer.

2.17 Given the lack of business history for Open Door, estimating a credit risk premium is challenging. Erring on the side of caution and taking into account its ultimate parent, which could be expected to lend support where not in contravention of state aid rules, and the riskier development period, a BB or BBB rating may be appropriate.

2.18 Historical evidence shows that 10.8% of organisations with a Moody's credit rating in the "BBB" range have defaulted within twenty years, giving a discounted annual risk figure of 0.36% for a maturity loan. 20 years is the longest period for which the information is available.

2.19 For a "BB" rating, the cumulative historical default rate for 20 years is 33.4%, which equates to a discounted annual risk premium of 1.12% for a maturity loan. The BB rating may be more appropriate given that the loan does not pay interest live for the development period and the repayment schedule relies on the success of the development.

2.20 Adding the credit risk margin to the PWLB rate gives one measure of the minimum acceptable interest rate on the loan between 3.80% and 4.56% for 40 years.

### State Aid

2.21 Any support provided by the Government (including public bodies such as local authorities) to businesses must be compliant with the European Union regulations on State Aid. If the Council provided funding at a lower interest rate than would be secured by commercial organisations that could be in competition with the borrowers, this would likely constitute state aid. Although not all state aid is illegal, it would bring a host of complications, and is best avoided.

2.22 Open Door have stipulated that the loan will be used for “Affordable Housing” development only, and as such would potentially secure exemption from State Aid if challenged, however, State Aid is still a useful approach to judge potential rates achievable in the market.

2.23 The European Commission publishes guidance on the base reference rate for each member state, and the appropriate margin to reflect the level of collateralisation and creditworthiness of the borrower. This approach results in the calculation of lending rates which are deemed to be a proxy for the prevailing market rate; loans made at higher rates do not give rise to State Aid.

2.24 The current published base reference rate for the UK is 1.02% for all maturities. The margin to be added is taken from the following table.

| | Collateralisation | | |
|---|---|---|---|
| **Creditworthiness** | **High** | **Medium** | **Low** |
| Strong (AAA-A) | 60 | 75 | 100 |
| Good (BBB) | 75 | 100 | 220 |
| Satisfactory (BB) | 100 | 220 | 400 |
| Weak (B) | 220 | 400 | 650 |
| Bad / Financial Difficulties (CCC and below) | 400 | 650 | 1000 |

(ref. Official Journal of the European Union - Communication from the Commission on the revision of the method for setting the reference and discount rates (2008/C 14/02))

2.25 We would categorise the proposed loan as having “normal” collateralisation, rather than “low” or “high”, to use the EC terminology. This is because security on property is standard for loans to registered providers. The security of the property is likely to limit any potential loss on default, dependent on any restrictions on property usage imposed by the Council.

2.26 Open Door has no credit rating and no business history. This suggests credit strength of B or none, although the effective control by Barnet Council may be a significant credit positive (as discussed in the previous section). Based on the level of collateralisation in 3.15, this generates a margin of 4.00%.

2.27 This is in line with the state aid guidance, which suggests that a company without a business history should receive a margin of at least 4.00%.

2.28 Adding the margin to the reference rate gives the minimum rate for State Aid purposes of 5.02%. This is somewhat higher than the highest minimum rate determined in paragraph 3.12 (4.56%). To avoid any state aid implications, if challenged, the rate would have to be at least 5.02%, although as the loan is for “Affordable Housing” only the transaction is judged to fall outside State Aid regulations, as such 4.56% remains relevant.

### Alternative Lenders

2.29 Larger RPs borrow by issuing bonds, whose prices and yields are publicly available. A number of aggregation vehicles for smaller housing associations also issue bonds of similar credit quality, although smaller associations tend to pay higher rates. The repayment structure of the loan based on the business model means that the average life will be around 30 years. The details of a selection of bulletin maturity bonds with remaining lives of around this term are given below.

| Creditworthiness | Maturity | Bond Yield | Margin Over Gilts |
|---|---|---|---|
| Amicus Horizon Group | March 2043 | 3.88% | 1.30% |
| The Housing Finance Company | Oct 2043 | 3.86% | 1.30% |
| London & Quadrant Housing Trust | Oct 2049 | 3.64% | 1.13% |
| Average | | **3.79%** | **1.24%** |

Source: Bloomberg

2.30 The loan to Open Door includes a period where interest is not paid live, instead being capitalised and repayment only when the business begins to make surpluses. This level of flexibility is not likely to be available via a bond issue.

2.31 A private placement with a financial institution (e.g. pension fund) may be more appropriate. Rough private placement margins are between 1.5% and 2.0% over gilt yields.

2.32 In either case, the level of flexibility in the facility being considered and the credit risk of the loan are likely to incur a significant premium. An appropriate estimate could be between 1.5% and 2.0% on top of the above rates.

2.33 Added to the broad average of the above bond rates of 3.80%, we could expect a market rate for a secured maturity 30 year loan to be around 5.80%. The private placement rate could be as much as 6.55%.

### Interest Rate Summary

2.34 The state aid regulations suggest that a rate of 5.02% is the minimum rate the Council can charge and as we understand it this is the rate that the current business plan is based upon.

2.35 Whilst the rate of 5.02% is below the maximum market rate that we feel Open Door would access if they went to the market this is above the minimum rate of 4.56% that we have calculated from our assessment of the potential credit strength of the new organisation

2.36 Taking the above considerations into account, we advise that the loan rate could be between **4.56%** and **5.80%,** derived using the methods described through this report. This range has been discussed with the Council and an appropriate rate of 4.56% has been agreed

### Risks to be considered

2.37 There are a number of risks to be considered in the context of this loan, the most likely of which is that the UK interest base rate as set by the Bank of England changes between now (September 2015), and the actual time when the loan is taken out. There is a widely held view that this rate will rise at some stage in the medium term, a change which is likely to increase the applicable reference rate in this instance. It is of course not possible to know when this change will take place nor how significant it will be. Indeed events may dictate that it doesn't happen before the loan is granted, if at all, or even that a further decrease is the outcome. Further, the expectation of an interest rate rise will to some extent already have been factored into the 1-year rate used as a basis for the reference rate so some of the impact may have already been mitigated. The risk has been considered in the sensitivity analysis below.

2.38 There is a further risk that the proposed legal structure of the loan suggests that the minimum collateralisation of 70% cannot be guaranteed, or that the asset value falls beneath 70% of the loan value and therefore the margin applied must be increased accordingly. This risk can be fully mitigated through careful drafting of the loan agreement to ensure such guarantees are in place.

## Benchmarking against other Authorities

2.39 In addition to the above analysis it is important to consider the precedents for the Council providing funding to the new RP. In order to complete this the review team discussed the approach with a variety of Authorities who have undertaken this role across the Country as well as bringing to bear the knowledge and experience of the review team from reviewing similar arrangements. The list of organisations consulted or used for benchmarking is included at Appendix A. The key findings of this work are included below:

- **Risk management Workshops** – In order to generate consistent commitment and buy-in from key stakeholders, including Members from all political parties, one of the consulted authorities undertook a series of stakeholder and risk workshops at which experts from the finance and treasury management industries explained the process, implications, potential benefits and risks, and appropriate mitigating actions. These workshops are seen by the Council as one of the most important elements of the process as they help to establish a stable political platform upon which the significant long-term investment into the local housing market could be made.
- **Governance** – One of the key consultees raised the importance of the governance process around the loans it made to RPs. Initially oversight was provided through the Council's Audit and Corporate Governance Committee, however, the need to focus more time and challenge on these loans resulted in the establishment of a Treasury management Board to specifically scrutinise these investments.
- **No Commitment Fees** – It has become an accepted principle within the market of not applying commitment fees to investments. Typically a private bank investment would apply these costs but a number of the Authorities who have been undertaking RP loans have decided not to apply these.
- **Manage risk through variance of covenants** – A number of consultees explained that it was possible to keep the rates on the lower end of the spectrum expected by applying more stringent covenants. For example one consultee typically inserted a 120% loan to value covenant but that this had been increased to 150% to a higher risk RP and thus keeping the rate lower. This could be applied here to justify a rate towards the lower end of the spectrum.
- **Independent View on Interest Rate** – Consultees made clear that it is possible for the Council to define the interest rate to be used but that this to provide extra rigour this rate should be confirmed through an independent FCA regulated third party. Through this approach an appropriate regulated advisor will ensure that the rate charged meets the risk profile and market expectations the Council should comply with. A number of consultees employ this third party to define the rate for them based on financial due diligence and market research. Arlingclose have advised on this aspect of this review and their advice is included within this report.
- **Length of Loan** – The consultees made clear that the period of the loan was a product of the business plan submitted and that this could, in their experience, vary from 10 to 45 years. A variety of loan repayment terms have been used within these business plans including a bullet payment approach where interest only is charged in the early years in order to alleviate challenges to viability prior to rental income realisation with a bullet payment at staggered points.
- **Apply "Wednesbury Principle"** – One of the consulted Authorities explained that they always consider whether they are applying the "Wednesbury Principle". This is a principle of acting "reasonably" in undertaking these investments defined as follows '… a person entrusted with

a discretion must, so to speak, direct himself properly in law… if 'he does not obey those rules, he may truly be said, and often is said, to be acting "unreasonably"'

## Financial Modelling Results

2.40 Based on the changes detailed in the sections above this section summarises the findings emerging from the review. These are presented in the following way

- **Varying Interest Rate** – Because the rate recommended has been set as a range between 4.56% and 5.80% three versions of the baseline scheme are presented to show the impact of this variation – 4.56% 5.02% and 5.80%
- **Varying the build cost** – In order to demonstrate the sensitivity of the build cost the baseline scheme is shown with a plus or minus 5% and 10% build cost to show this impact.
- **Up front funding within the HRA** – There is the potential for the Council to incur some of the costs within the HRA in advance of transferred the land to the new RP. In this circumstance these costs would be incurred by the Council and paid back from "super profits" at the end of the scheme. This option demonstrates the impact of this is shown

2.41 A detailed table of assumptions used within the model are included at Appendix B.

2.42 A baseline assumption within the model is also a cost to the RP of £2,000 per unit per annum. This is a premium that is paid to the Council for each unit completed as agreed between the two parties.

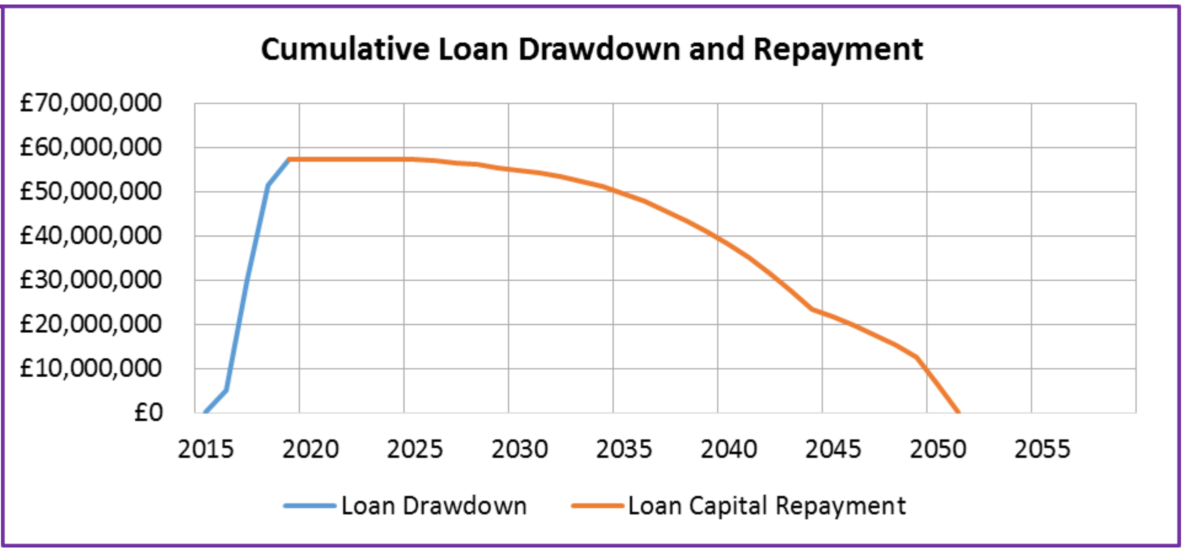
### Varying the Interest Rate

Loan at 4.56%

2.43 If the lowest interest rate recommended is used (4.56%) it produces the following results

| | |
|---|---|
| Development Cost | 52,512,000 |
| Company Operational Cost | 1,551,000 |
| Capitalised Interest & Arrangement Fee | 4,848,000 |
| Net Rental Income | -2,854,000 |
| Required Working Capital Reserve at end of Dev. | 1,398,000 |
| Council HRA Funding | 0 |
| **Total Loan Facility** | **57,454,000** |
| **Blended Interest Rate** | **4.56%** |
| **Interest Only Period (Years)*** | **4** |
| **Payoff Period (Years)*** | **32** |

2.44 This demonstrates that a total loan of £57.5m is required. This is then paid back over 32 years with interest only being paid over the first 4 years and then any excess cash being used over a £1m float to pay down principal over the life of the loan. This is exemplified in the graph below.

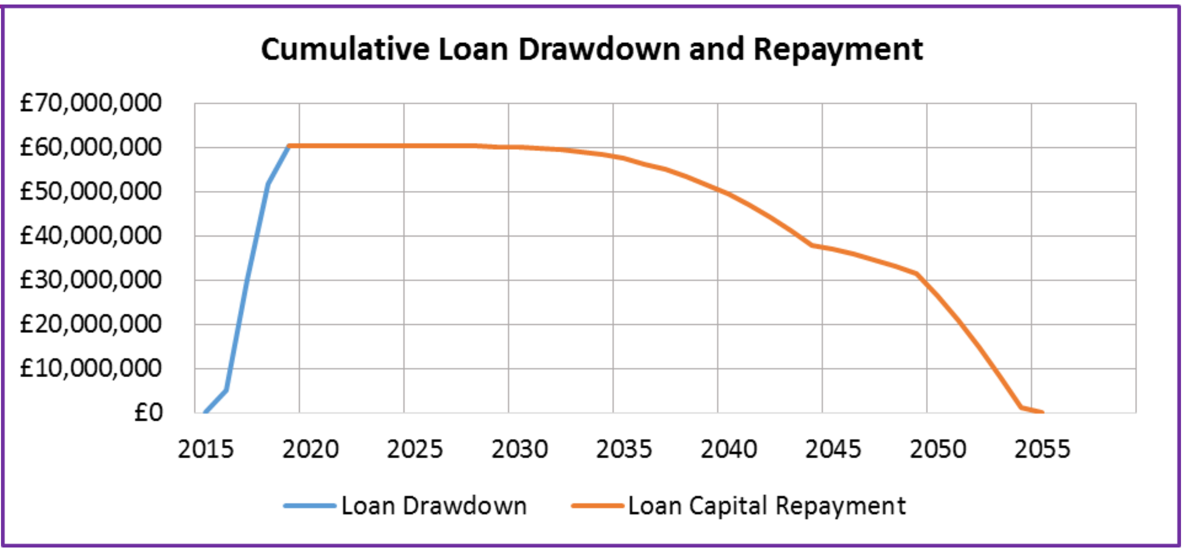



Loan at 5.02%

2.45 If a more risk averse rate were used of 5.01% it produces the following results

| | |
|---|---|
| Development Cost | 52,512,000 |
| Company Operational Cost | 1,551,000 |
| Capitalised Interest & Arrangement Fee | 5,336,000 |
| Net Rental Income | -2,854,000 |
| Required Working Capital Reserve at end of Dev. | 3,844,000 |
| Council HRA Funding | 0 |
| **Total Loan Facility** | **60,388,000** |
| **Blended Interest Rate** | **5.02%** |
| **Interest Only Period (Years)*** | **8** |
| **Payoff Period (Years)*** | **36** |

2.46 This demonstrates that a total loan of £60.4m is required. This is then paid back over 36 years with interest only being paid over the first 8 years and then any excess cash being used over a £1m float to pay down principal over the life of the loan. This is exemplified in the graph below.

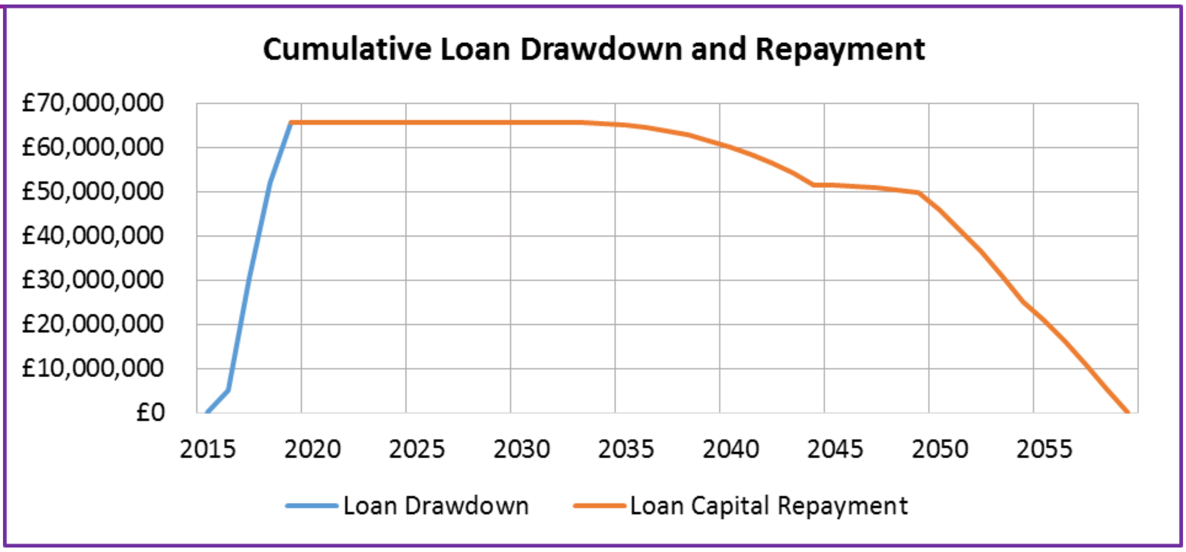



Loan at 5.30%

2.47 The recommended rate is between 4.56% and 5.80%. The baseline scheme is not viable at 5.80% as the loan cannot be repaid over 40 years. The peak rate at which the loan can be repaid over this period is 5.30% this produces the following results

| | |
|---|---|
| Development Cost | 52,512,000 |
| Company Operational Cost | 1,551,000 |
| Capitalised Interest & Arrangement Fee | 5,677,000 |
| Net Rental Income | -2,854,000 |
| Required Working Capital Reserve at end of Dev. | 8,744,000 |
| Council HRA Funding | 0 |
| **Total Loan Facility** | **65,629,000** |
| **Blended Interest Rate** | **5.30%** |
| **Interest Only Period (Years)*** | **14** |
| **Payoff Period (Years)*** | **40** |

2.48 This demonstrates that a total loan of £65.6m is required. This is then paid back over 40 years with interest only being paid over the first 14 years and then any excess cash being used over a £1m float to pay down principal over the life of the loan. This is exemplified in the graph below.




2.49 This demonstrates that the baseline scheme is viable within a 40 year payback period between 4.56% and 5.30% and the Council could loan at any rate along this spectrum

### Varying the Build Cost

2.50 Clearly there are risks, both upside and downside, to each of the core assumptions. The most likely of these to effect the scheme are those in relation to build costs. As the rent is linked to affordable use, this income stream is unlikely to vary significantly, as such this section will model the impact of varying this key assumption. The core scheme is used as a baseline at a 4.56% loan rate.

2.51 The table below shows the impact on the level of loan required and the payback period for the debt by varying the build cost assumptions

| Build Cost Variation | Value of Loan | Payback period |
|---|---|---|
| -10% | 50,629,000 | 27 |
| -5% | 53,930,000 | 31 |
| 0 | 57,454,000 | 32 |
| +5% | 61,326,000 | 34 |
| +10% | 65,614,000 | 37 |

### Delays in development

2.52 The other key variable that could impact the loan and its repayment terms id the potential for development to be delayed. The table below shows the impact of a 2, 4 and 6 month delay on the development across the phasing. The core scheme is used as a baseline at a 4.56% loan rate.

2.53 The table below shows the impact on the level of loan required and the payback period for the debt by varying the scheme delivery timetable assumptions

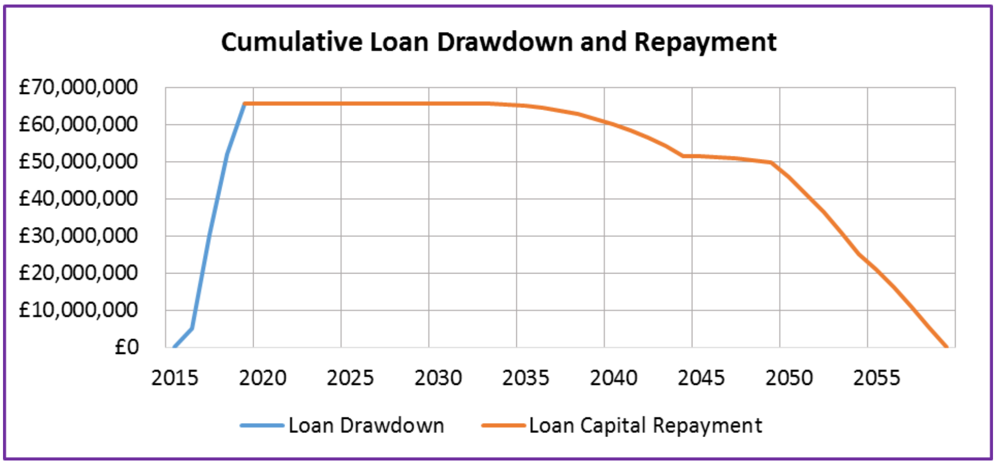
| Scheme Delay Variation | Value of Loan | Payback Period |
|---|---|---|
| Core scheme | 57.5 | 32 |
| 2 month delay | 58.2 | 33 |
| 4 month delay | 59.0 | 33 |
| 6 month delay | 60.1 | 34 |

### Up Front Funding Within the HRA

2.54 The Council has considered undertaking some of the early works on the scheme within the HRA before the land transfer to the new RP. The initial £3.7m loan detailed above is used to fund preliminary works to the sits in advance of development. There is the potential for the Council to undertake these works within the HRA before the land is transferred to the RP and for the scheme to repay these from profits over time. This would, in essence, be treated as an equity investment by the HRA into the scheme having the resultant impact of saving the early years funding costs and repaying these funds from profits at the back end of the scheme

| | |
|---|---|
| Development Cost | 48,812,000 |
| Company Operational Cost | 1,551,000 |
| Capitalised Interest & Arrangement Fee | 4,252,000 |
| Net Rental Income | -2,854,000 |
| Required Working Capital Reserve at end of Dev. | 750,000 |
| **Total Loan Facility** | **52,510,000** |
| Council HRA Funding to be Repaid | 3,700,000 |
| **Blended Interest Rate** | **4.56%** |
| **Interest Only Period (Years)*** | **2** |
| **Payoff Period (Years)*** | **30** |

2.55 The table demonstrates that undertaking these works within the HRA prior to transfer significantly benefits the scheme with the total loan required falling to £52.5m from £57.5m. A fall of £5m due to the associated funding costs. This enables pay back of the funding two years earlier as shown by the graph below. This has a total financial benefit to the scheme of £1.3m as shown in the graph below.



## Accounting Treatment

2.56 As part of this review 31ten has reviewed relevant accounting practice and had discussions with comparable Authorities who are engaged in loans to RPs in order to establish the appropriate accounting treatment for the Council.

2.57 The introduction of the prudential capital finance system on 1 April 2004 allowed local authorities to have relative freedom to make their own borrowing, investment and lending decisions, albeit governed by The Prudential Code for Capital Finance which aims to ensure that capital investment plans are affordable, prudent and sustainable.

2.58 The Council will be making a loan to the new RP as part of its Council's capital programme, as such the treatment of the loan as capital expenditure is set out in the SI 2003 No 3146[1] - regulation 25 1) b):

> *25.—(1) For the purposes of Chapter 1 of Part 1 the following expenditure of a local authority, incurred on or after 1st April 2004, shall be treated as being capital expenditure insofar as it is not capital expenditure by virtue of section 16(1) —*
>
> > (*b) subject to paragraph (2), the giving of a loan, grant or other financial assistance to any person, whether for use by that person or by a third party, towards expenditure which would, if incurred by the authority, be capital expenditure;*

2.59 The cumulative balance of the loans is then held as a *Long Term Debtor* in the Council's balance sheet that is repaid over time and therefore unwound.

2.60 The Council's Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Strategy set out the Council's strategy and policies for the Council's capital and investment plans, including plans for borrowing and managing its investments. Should the Council decide to borrow the funds, it should consider the implication of this borrowing on its current Treasury Management Strategy. Any adjustment to this statutory policy will need to be formally agreed in line with the Council's governance structure.

2.61 The Council does not need to make an explicit statement in its Treasury Management Strategy regarding this use of borrowing. However, in the interests of transparency and to aid members understanding of the Strategy the Council may wish to include a note to accompany the indicators. This note should draw members' attention to the significant increase in the CFR, detailing that this increase relates to the loan to the new RP.

2.62 The Council's current MRP policy states

> *The Council will apply Option 2[3] in respect of supported capital expenditure and Option 3[4] in respect of unsupported capital expenditure.*

2.63 And also states

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[1] Statutory Instrument 2003 No. 3146: The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003

[3] Option 2 – CFR Method
[4] Option 3 – Asset Life Method

*The MRP Statement will be submitted to Council before the start of the 2015/16 financial year. If it is ever proposed to vary the terms of the original MRP statement during the year, a revised statement should be put to the Council at that time.*

2.64 The treatment of the MRP in this circumstance would not fall under options 2 or 3 as the loan itself is the repayment vehicle, therefore, the statement would suggest that the change in policy should be presented to Council, however this is for the Council to decide.

2.65 This treatment is similar to other councils we have contacted and is in line with councils that have made loans to Registered Providers.

2.66 Officers should ensure that the business case for the injection of senior debt is developed with regard to The Annual Investment Strategy and is subject to the Council's internal governance process in order to be approved.

### Other Considerations

2.67 Section 12 of the Local Government Act 2003 grants local authorities the power to invest for "any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs".

2.68 However, the Council will also want to ensure that it documents the approval to this option in such a way that it can either rely on s2 of the Local Government Act 2000 without contravening the LAML principle (that is that the lending to the new RP must be for the promotion or improvement of the economic social or environmental well-being of the borough and not just an exercise in financial engineering) and/or s12 of the Local Government Act 2003 where the Council has power to invest for the purposes of the prudent management of its financial affairs.

2.69 This issue will need to be addressed in the detailed work undertaken by the Council's legal advisors in developing the loan and security documentation to ensure the market position is achieved and to protect the state aid position if this option is chosen.

## Impact on the Council

2.70 This study has examined the potential for the Council to provide a loan to the new RP for the development of new units that the Council would utilise for its affordable housing need. In order to judge the deliverability of this arrangement it is important to model the impact of the loan on the Council's accounts. This section therefore examines the cumulative impact of the potential loan, and all costs and revenues that will result from it, on the Council.

2.71 The key impacts to the Council revenue account are as follows:

- **Margin on the loan** – The Council will accrue a cost of capital to secure the funds to loan to the RP, but will loan to the RP at a premium above this borrowing rate. The difference between these 2 rates will form an income stream to the Council. If it is assumed the Council secure borrowing over 32 years, in line with the viability appraisal requirements, for a loan at 4.56% then it could borrow from PWLB at 3.32%[5]. This would therefore secure a margin on this borrowing to the Council of 1.24%. It should be noted that the PWLB rate varies with gilt rates daily and should be reviewed in advance of calculating the final loan rate.

[5] PWLB published rates at 12th December 2015

- **£2,000 per unit per annum** – The new RP has agreed to make a payment to the Council of £2,000 per unit per annum across the life of the scheme.
- **Arrangement fee@ 1% of loan** – The arrangement fee has been calculated at 1% of the loan value and is payable to the Council.
- **Capitalised Interest Period** – During the development period the loan arrangements being put in place enables the RP to capitalise the interest due on the loan and the commitment fee. As a consequence there are no live payments made to the Council throughout this period. Instead the interest payments capitalised form part of the new loan balance and are repaid over the life of the loan. As a result the Council will incur costs on the capital it has loaned to the RP (assumed to be 3.32% as per above) and will not receive any income over this period to offset this. The Council would consider this risk in line with its broader treasury management policy in order to mitigate these costs by utilising capital here appropriate.

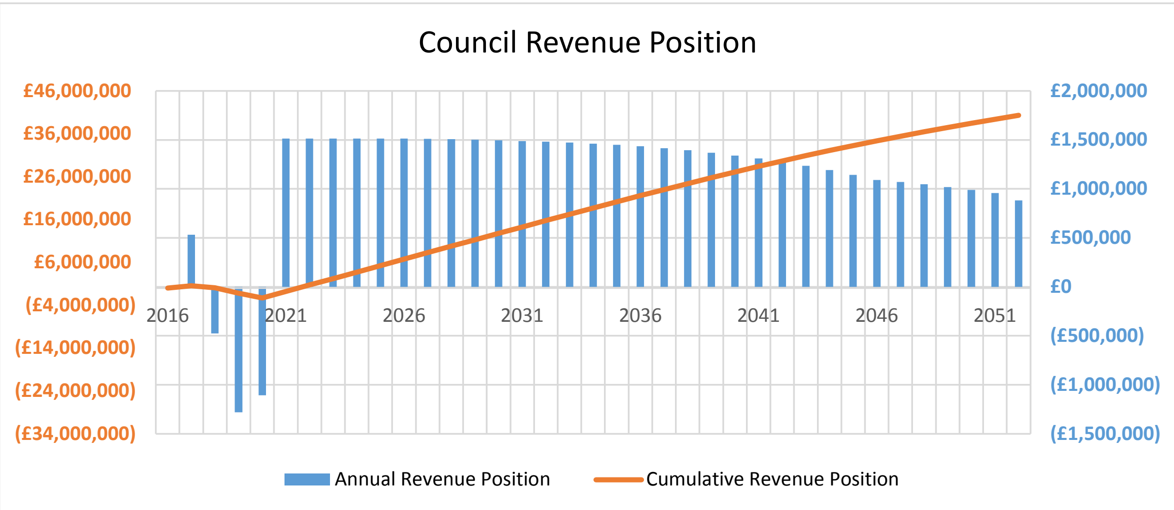
2.72 The table below shows the potential net income receivable over the life of the loan assuming the following loan arrangements:

- Council cost of funds - 3.32%;
- Loan to Open Door at 4.56%
- Interest only payments for the first 4 years;
- Loan repaid over 32 years.

2.73 The table shows the total net income receivable for each element and the Net Present Value (NPV) of these income streams.

| Council Revenue | | |
|---|---|---|
| **Revenue Type** | **NPV (6.09%)** | **Gross Amount** |
| **Interest Margin** | 6,300,000 | 19,230,000 |
| **LBB £2k Payments** | 7,040,000 | 20,480,000 |
| **Arrang. Fee** | 570,000 | |

2.74 This demonstrates a total net income to the Council over the life of the project of £40.2m which has an NPV of £13.9m. The most significant impacts however are in the timing of these effects on the revenue account. This is demonstrated in the graph below.



2.75 The graph shows that the Council achieve significant rewards over the life of the project with income to the Income and Expenditure account of between £1.5m and £0.6m annually over the life of the project, excluding the development period. However, assuming the Council did borrow at 3.32% to fund the loan it would incur unmatched costs to the revenue account in years 2-4 of between £0.4m and £1.2m that it would need to fund.

## Summary

2.76 This study has undertaken a review of the business case pulled together by Barnet Homes for the development of an initial tranche of 320 homes utilising funding provided by London Borough of Barnet.

2.77 This report proposes an appropriate loan rate of 4.56%, which can be repaid over 32 years, assuming approval is granted by the HCA for the creation of Barnet Homes, RP subsidiary, Open Door. However, the Council may want to allow Open Door some contingency to provide for variation in build costs or phasing.

2.78 The impact on the Council of making such a loan is significant. It realises substantial returns on the arrangement over the life of the loan, however, there are potential costs to the revenue account in the early years that need to be mitigated through its treasury management arrangements.

2.79 The Council need to develop robust legal documentation around this potential facility, including a loan agreement that clearly delineates the new RP from its parent body and the Council, to ensure clarity over where the liability is held for the borrowing, the level of parent company support and the appropriate covenants, step in rights and default provisions.

# Appendix A – Benchmark Local Authorities

- London Borough of Bexley
- London Borough of Brent
- Broxbourne Borough Council
- Croydon Council
- London Borough of Ealing
- London Borough of Lewisham
- South Cambridgeshire District Council
- Warrington Borough Council

# Appendix B – Financial Model Assumptions

| Development Assumptions | |
|---|---|
| Build Cost (£/Sqm GIA) | £1,934 |
| Dev. Allowances (% of Cost) | 14% |

| Development Period Phasing | |
|---|---|
| Cash Flow Start Date | Apr-16 |
| Construction Month Start (69 Units & 101 Units) | Apr-16 |
| Construction Month End (69 Units & 101 Units) | Nov-18 |
| Construction Month Start (150 Units) | Apr-16 |
| Construction Month End (150 Units) | Nov-19 |

| Rental Costs/Voids | | | | | |
|---|---|---|---|---|---|
| Management (£/Unit) | Maintenance (£/Unit Incl. VAT) | Other Costs (£/Unit) | Voids (% of Gross Rent) | Bad Debts (% of Gross Rent) | Letting/Other Fee (% of Gross Rent) |
| £295 | £720 | £2,000 | 2.0% | 4.0% | 0.0% |

| Company Management Costs | Amount |
|---|---|
| During Development Period | £1,550,000 |
| Operational Period* (Per Annum) | £1,318,000 |

***Variable inflation at an average of 1.63% per annum**

| Grants | Amount | Month |
|---|---|---|
| GLA Grant | £2,465,000 | Oct-18 |

| LHA Levels - Rental Value per week | | | | | | |
|---|---|---|---|---|---|---|
| Location | Bedrooms | | | | | |
| | 0 | 1 | 2 | 3 | 4 | 5 |
| NW London | £87 | £186 | £242 | £303 | £374 | £374 |

| Inflation Levels - PH1. 69 Units | | | | | | |
|---|---|---|---|---|---|---|
| Inflation Period | Management Cost | Maintenance Cost | Other Cost | Major Repairs / Rebuild | Rent | Property Value |
| Inflation level - Year 1 | 2.50% | 2.50% | 0.00% | Custom Schedule | -1.00% | 4.00% |
| Inflation level - Year 2 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 3 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 4 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 5 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 6 to 10 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 11 to 20 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 21 to 30 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 31 + | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |

| Inflation Levels - PH1. 101 Units | | | | | | |
|---|---|---|---|---|---|---|
| Inflation Period | Management Cost | Maintenance Cost | Other Cost | Major Repairs / Rebuild | Rent | Property Value |
| Inflation level - Year 1 | 2.50% | 2.50% | 0.00% | Custom Schedule | -1.00% | 4.00% |
| Inflation level - Year 2 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 3 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 4 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 5 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 6 to 10 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 11 to 20 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 21 to 30 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 31 + | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |

| Inflation Levels - PH2. 150 Units | | | | | | |
|---|---|---|---|---|---|---|
| Inflation Period | Management Cost | Maintenance Cost | Other Cost | Major Repairs / Rebuild | Rent | Property Value |
| Inflation level - Year 1 | 2.50% | 2.50% | 0.00% | Custom Schedule | 3.00% | 4.00% |
| Inflation level - Year 2 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 3 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 4 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 5 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 6 to 10 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 11 to 20 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 21 to 30 | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |
| Inflation level - Year 31 + | 2.50% | 2.50% | 0.00% | | 3.00% | 4.00% |

| | |
|---|---|
| Rental Adjustment | 98.01% |

| | |
|---|---|
| **Weeks Per Year (Rental Income Calculations Only)** | 52.2 |

| Loan Inputs | |
|---|---|
| Arrangement Fee (% of Loan) | 1.0% |