**Summary of main points regarding Scottish Government proposed council/RSL subsidy benchmarks**

26 April 2020

Summary

Following the meeting between Cosla, ALACHO and the Scottish Government on 20 April, the Scottish government was asked to provide further evidence to justify its proposal for increased council benchmarks. This paper seeks to provide that evidence based on three core elements;

(a) An explanation of the different nature of the lending sources (PWLB vs bank)

(b) A more accurate comparison of the interest rates for new lending than that contained in the paper submitted by ALACHO (by comparing interest rates in both sectors for new loans), and

(c) Some further detail regarding additional costs borne by RSLs that are not borne by councils

Based on this evidence, the Scottish Government believes that the current offer is a reasonable one that is capable of being recommended to Ministers and Council Leaders and urges partners to coalesce around this proposal in order to make the strongest possible case for such a recommendation.

Evidence Summary

1 All partners have recognised that the origins of Scottish Government support for new affordable homes are quite different for councils than for housing associations. ALACHO has argued that, in the current circumstances, there is no justification for any difference between the two sectors – an argument for ‘parity’. Within that parity argument, ALACHO has argued for a single framework and also identical benchmarks.

2 In response, the SG has pointed out that over the past 5 years, 84% of council grant applications have sought grant at or below benchmark. At face value this does not suggest that the current benchmarks are wrong. However, all partners recognise the criticality of rent levels – particularly for our shared goal of tackling child poverty – and SG has therefore listened to ALACHO’s concern in this regard. Council rents are influenced by a wide range of factors such as expenditure on repairs, historical debt, management costs etc and decisions on these matters are taken by councils as they develop their HRA business plans. Through that process, councils also determine whether they wish to use HRA resources to support new build, and, if so, at what level. It is important that rents are kept affordable and if that affordability is in jeopardy then any one of the above factors (or a mix of them) could be the driver(s). Indeed, the influence of these various factors will no doubt be different for different councils.

3 Notwithstanding all of the above, the SG has proposed some significant changes to the benchmark regime including the following;

1. Significantly increasing the council benchmarks
2. Aligning the council benchmarks to the RSL ones by introducing the same geographical framework, using the same 3P equivalent and supplementing the benchmark for a variety of quality improvements (eg fire suppression)
3. Reviewing the benchmarks annually using the SSHTPI

The effect of these changes is to reduce the difference between council and RSL benchmarks to between 9 and 15% (Annex 2 illustrates the calculations used) in favour of RSLs. Annex 2 also provides a worked example of the new benchmarks when applied to a project.

4 The SG considers this to be a reasonable offer which is capable of being justified to Scottish Ministers and Council Leaders (despite the current 84% of current projects from councils coming in at or below benchmark). In response, ALACHO believes that this is not a fair offer and seeks full parity.

5 Bearing in mind that these are benchmarks and not grant levels, the system does not need to be 100% precise in every respect. It needs to be workable by ensuring only a manageable proportion of projects require above benchmark VFM scrutiny. It is also preferable that the new benchmarks can be agreed by partners and presented as a united proposal to Ministers and Leaders. And also that this discussion is concluded timeously so that we can all get on with building urgently needed affordable homes as effectively and quickly as possible.

6 With the aim of progressing this important issue, SG has therefore summarised below its reasoning for the proposal that has been made.

Summary of reasoning behind the proposal

7 84% of council projects are currently seeking grant at or below benchmark.

8 Councils and RSLs operate under very different financial constraints/opportunities. For example;

* Councils are seen by investors as inherently lower risk than RSLs
* Councils are financially multi-faceted and have flexibility/opportunities that are not available to RSLs. It is recognised that not all councils would choose to take up such options and it is recognised that their financial strategies are self-determined. Nevertheless, councils can choose to reduce the discount on second homes and use the additional income for new affordable housing (in 20/21, 25 councils removed the discount and 6 retained the 10% discount[[1]](#footnote-1)). Also, as highlighted by ALACHO, councils have, at times, chosen to contribute land at nil or less than market value for affordable housing. It is recognised that this has become more challenging in recent times.
* Councils can access the PWLB (now the Debt Management Office) and RSLs cannot. The PWLB charges at a small margin above UK Government Gilts – that is slightly higher than the UKGov itself borrows at. This is therefore not a bank lending rate and is consistently lower than the bank lending that most RSLs rely on (Bonds for the larger RSLs may get closer to this rate). **The revenue costs of borrowing are about 50% higher for RSLs than for councils (see Annex 1).**

9 A full analysis of the different financing regimes would be time-consuming and expensive. Such a study is not considered necessary because we are only talking about benchmarks and in that sense great precision is inappropriate. However, recognising that ALACHO has sought as much evidence as possible, Annex 1 to this paper contains some more specific analysis to support the above general evidence.

Conclusion

10 The evidence suggests that councils are able to access cheaper borrowing than RSLs and in a much more straightforward manner. This, combined with the different financial nature of the two sectors and the fact that most councils are currently applying for grant at or below benchmark demonstrates that the proposal from the SG is a reasonable one. Partners have committed to monitoring the operation of the benchmarks and to review them annually. This offers reassurance that if a further correction is needed, then that can be considered.

11 All partners should now coalesce around this proposal and work jointly to present it to Leaders and Ministers in the most effective way.

Annex 1: More detail on relative borrowing costs for councils and RSLs

1 Comparison of borrowing costs

Interest rates for RSLs are published in the SHR’s Annual Loan Portfolio Returns (Technical Appendix) and show the median for new loans fixed rate lending as follows;

|  |  |
| --- | --- |
| 2017/18 | 3.64% |
| 2018/19 | 3.72% |
| 2019/20 | 2.80% (Not yet published) |

Interest rates for councils (formerly known as PWLB) are published by the UK Debt Management Office (DMO) and the March 2020 figures were;

|  |  |
| --- | --- |
| 30 years | 1.96%[[2]](#footnote-2) |
| 20 years | 1.88% |
| 10 years | 1.38% |

RSLs typically have a ‘revolving credit facility’ of, say, 3 years which is drawn down and repaid as individual needs arise during development. They then have longer term financing which is reviewed periodically. The flexibility of these longer-term arrangements varies over time and is seen as good just now. Back in 2009, banks only offered short term deals. However, even at present, few RSLs can access 30-year fixed term rates and 15 or 20 years is more typical. By way of comparison, the figure of 2.8% for RSLs is highlighted in red, as is the 1.96% for councils – a difference of about 0.85% for the lowest rates. **This difference equates to nearly 50% higher borrowing costs for RSLs** (the revenue costs of borrowing at 3% will be about 50% higher than borrowing at 2% as per the following example);

£100 borrowed at 2% will require interest to be paid of £2

£100 borrowed at 3% will require interest to be paid of £3

£3 is 50% more than £2

This can be further illustrated by looking at the cumulative effect of higher interest rates on borrowing of £150k over 30 years;

|  |  |  |  |
| --- | --- | --- | --- |
| Interest rate | 2.15% | 2.65% | 3.15% |
| Term | 30 | 30 | 30 |
| Loan value | £150,000 | £150,000 | £150,000 |
| Cumulative interest paid | £55,092 | £69,322 | £84,061 |
| Additional interest  |  | £14,230 | £28,968 |

Source; Scottish Gov Analysts

The point of these illustrations is to emphasize that small differences in interest rates can make a big difference to the revenue costs of funding that borrowing and lead to significant additional interest over the life of the loan.

2 Reported HRA pool rates

ALACHO submitted figures (based on the published HRA estimates for 20/21) which stated;

“The … figures [for councils] show rates ranging from 2.58% to 5%”

The ALACHO paper also considers total interest payments from the HRA against total debt and concludes that the overall interest rate on that basis is 3.57%.

Looking at the published tables, the actual median for these figures is 3.8%.

However, these figures are not comparable with those in section 1 above. Those in section 1 above refer to interest rates on NEW lending. Those quoted by ALACHO from the HRA returns are HISTORICAL debts (ie ALL debt). Councils will be paying interest on loans taken out when interest rates were much higher and these will vary over time. Interest rates for more recent loans will be much lower than those taken out 30 years ago, for example.

It is suggested that the cost of new borrowing is a more meaningful figure upon which to base discussion than is the historical, aggregated cost.

3 Other costs

Under the PWLB, councils typically borrow annually to meet all the planned investment across all council services for a given year. Individual projects are then ‘called off’ from that provision. It is a simple mechanism – sometimes referred to as a ‘cashpoint’ – where individual service investments are not scrutinised by lenders.

In contrast, RSLs incur significant costs in applying for loans, administering them and reporting on them. For example, RSLs pay arrangement fees (typically 0.5 – 1.0% of loan value) and they incur valuation and legal costs relating not only to the new homes but also those being used as security. The latter typically require to be revalued periodically (typically every 3 years) and the services of a security trustee/asset manager (eg Prudential) will be required to endorse the transaction. RSLs then have a range of reporting arrangements such as annual funder meetings and covenant reporting.

Annex 2: Council Social Rent Proposed Benchmarks - Calculations

|  |  |  |  |
| --- | --- | --- | --- |
| **COUNCIL SOCIAL RENT** | **REMOTE RURAL** | **RURAL** | **CITY/URBAN** |
| CURRENT | 57000 | 57000 | 57000 |
| REDUCE DIFFERENTIAL TO CURRENT RSL SOCIAL RENT BY 50% | 12500 | 7500 | 6500 |
| MIRROR GEOG DIFFERENTIAL | 5000 | 3000 | 0 |
| SUB-TOTAL | 74500 | 67500 | 63500 |
| INFLATION AT 3% | 2235 | 2025 | 1905 |
| **NEW BENCHMARK** | **76735** | **69525** | **65405** |

**Council Social Rent – Comparison of Existing and Proposed Benchmarks**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Remote Rural** | **Other Rural** | **City/Urban** |
| Current council benchmark (flat rate) | £ 57,000 | £ 57,000 | £ 57,000 |
| Proposed benchmarks (3 person equivalent) | £76,375 | £69,525 | £65,405 |
| Difference | + £19,375 | + £12,525 | + £8,405 |
| Comparison to proposed RSL benchmarks | £89,610(85%) | £77,250(90%) | £72,100(91%) |
| Current Additional Greener Benchmark (flat rate) | £2,000 | £2,000 | £2,000 |
| Proposed Additional Greener Benchmark (3 person equivalent) | £2,000 | £2,000 | £2,000 |
| Suite of additional features  | All on a 3 person equivalent basis |

**City/Urban Example**

A 24 unit development with the average size of home being 4 person, being delivered to the greener standard and requesting £1.7m in grant. This would equate to £70,833 per home and be above the current applicable benchmark level (£59,000) and therefore require further scrutiny.

If delivering against the proposed new benchmarks then this project would be assessed against a three person equivalent benchmark of £67,405. The required grant per home of £70,833 would then have a conversion factor of 109.0 applied to it to reflect the average home size being 4 person which would equate to a 3 person equivalent benchmark of £64,984. The project would be under benchmark and receive a streamlined appraisal.

|  |
| --- |
| ***Project information (the following example relates to a council social rent – greener project in a City/Urban area):***  |
| *Number of units (a)*  | *24* |
| *Number of bedspaces (b)*  | *96*  |
| *Average bedspaces (b)/(a)*  | *4.0*  |
| *Total proposed grant (c)*  | *£1,700,000*  |
| *Average proposed grant per unit (c)/(a)*  | *£70,833*  |
| *Three-person equivalent conversation factor*  | *109.00*  |
| *Apply conversion factor to average proposed grant per unit (£70,833 divided by 109.0 multiplied by 100) (d)*  | *£64,984*  |
| *Compare (d) with the relevant three-person equivalent grant subsidy benchmark of £67,405 per unit*  |  |

*Project under benchmark at £64,984 per unit*

1. SG Quarterly Housing Stats Dec 20 [↑](#footnote-ref-1)
2. This is after the deduction of the 0.2% ‘Certainty Rate’: From 1 November 2012, the government introduced the Certainty Rate which reduced the PWLB standard interest rate by 20 basis points (0.20%) on loans from PWLB to principal local authorities who provide information as required on their plans for long-term borrowing and associated capital spending. All Scottish councils signed up to this. [↑](#footnote-ref-2)