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What's going on in Scottish local authority housing finance?

Briefing paper

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Introduction

In this briefing, initiated by the Scottish Government’s annual release of their Housing Revenue Account (HRA) trend statistics,¹ we consider the main trends and their implications and raise specific questions relating to rent levels, financial capacity for future investment and council housing business planning.

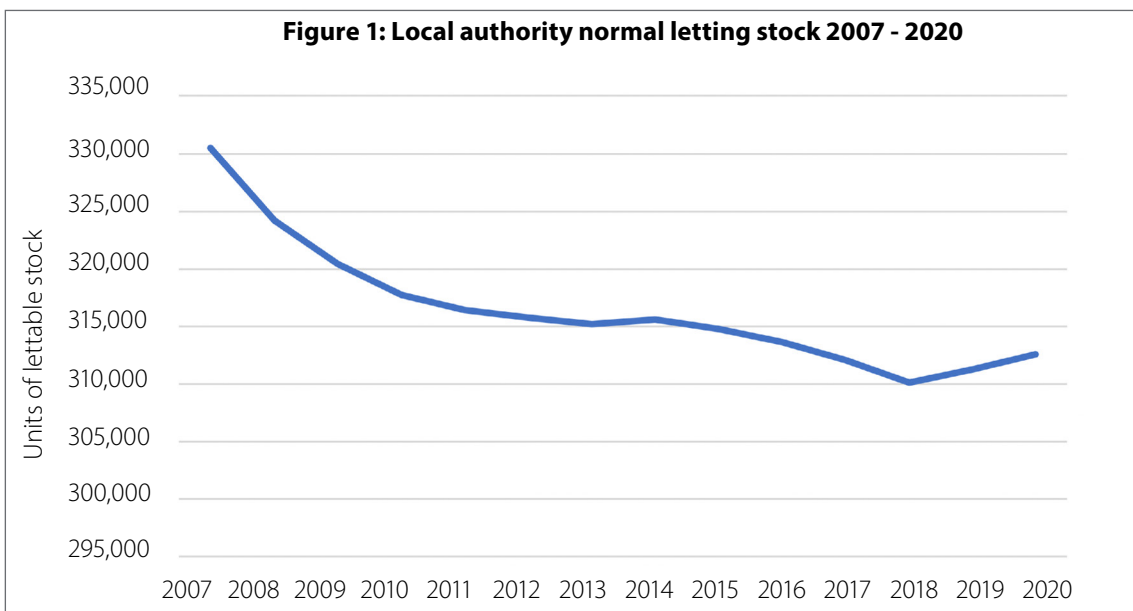
To put things in context, the reintroduction of capital grants for council house building in 2010 and the abolition of the right to buy in 2016 (after ending the RTB for new homes in 2009) has bought all 26 stockholding Scottish councils back into the business of building or buying to add to their housing stock to a greater or less extent. Other investment pressures, including the need to meet the Scottish Housing Quality Standard (SHQS) and the Energy Efficiency Standard for Social Housing (EESH) have largely been met but average rents have continued to increase above the rate of inflation.

In response both the Scottish Housing Regulator (SHR) and the Scottish Government have started to focus on affordability issues. In the Scottish Government’s case this has been largely in the context of its child poverty strategy² whilst the SHR has focused on emerging evidence of growing concerns about rents amongst social tenants³.

Independently of these developments, figures published by the Scottish Government show that 34% social housing tenants paid more than 30% of their net income on rents between 2015/16 and 2017/18⁴.

Housing Revenue Account (HRA) trends

The new HRA data provides a wealth of useful information, even if they often raise more questions than answers. We have picked out six key indicators (all diagrams use the new Scottish Government HRA statistics):



¹ [Housing Revenue Account \(HRA\) statistics: Scottish local authority housing income and expenditure 2018-2019 \(actuals\) and 2019-2020 \(estimates\)](#)

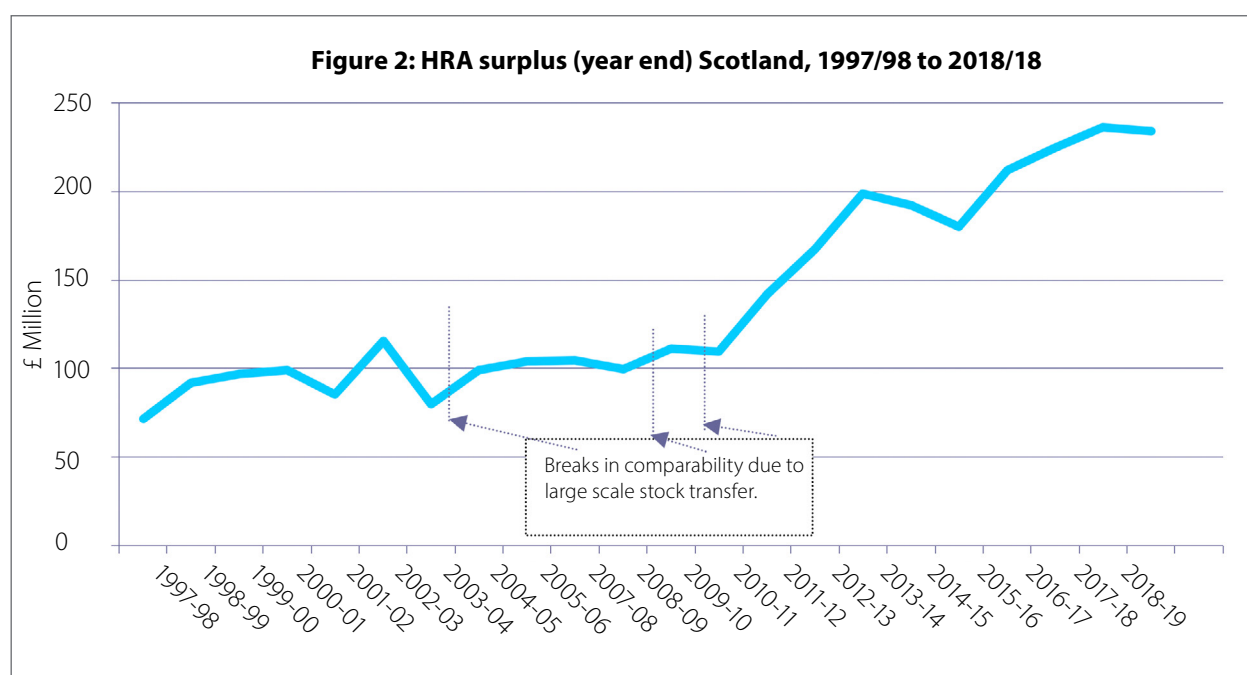
² [Every child, every chance: tackling child poverty delivery plan 2018-2022](#)

³ [Michael Cameron - TIS Rent Setting and Affordability event - 24 October 2019](#)

⁴ [Social tenants in Scotland 2017](#), Chart 5.17 PP 93

Stock numbers

After a generation of decline, driven initially by the right to buy and then by demolitions of low demand or poor-quality stock, the total number of Council homes has risen over the past two years. The rise isn't big, less than one percent since 2018 and it's pretty unevenly spread with 9 councils still showing a fall as a result of continuing demolitions. But it's difficult to underestimate the importance of this turn around. A generation of council staff and tenants have known nothing but decline. The start of a turn round in the number of council homes is what has underpinned a generally improving financial picture. But stock numbers remain over 11,000 homes lower than in 2007.



Surplus

As the chart above demonstrates, the level of gross surplus (after debt costs) has more than doubled since 2009/10. The overall surplus now represents around 20.6% of gross HRA rental income. Well over 90% of this surplus is invested in new or existing stock. As with every other element of HRA activity the figure varies significantly between councils ranging from 0% in Orkney and Renfrewshire to over 40% in the case of North Ayrshire (year to March 2019). What is perhaps a little less clear is what has driven this increase.

Operating costs

As the chart below shows, supervision and management costs per house have fallen from a peak around 2008 and have been broadly flat since 2015/16. The sharp drop and rise between 2016-2018 is currently subject to some revision. The authors are advised that this is likely to result in costs showing as flat during this period. The trend for repairs and maintenance costs (in the next chart) are broadly similar.

Figure 3: Supervision and management expenditure per house, Scotland, 1997-98 to 2018-19

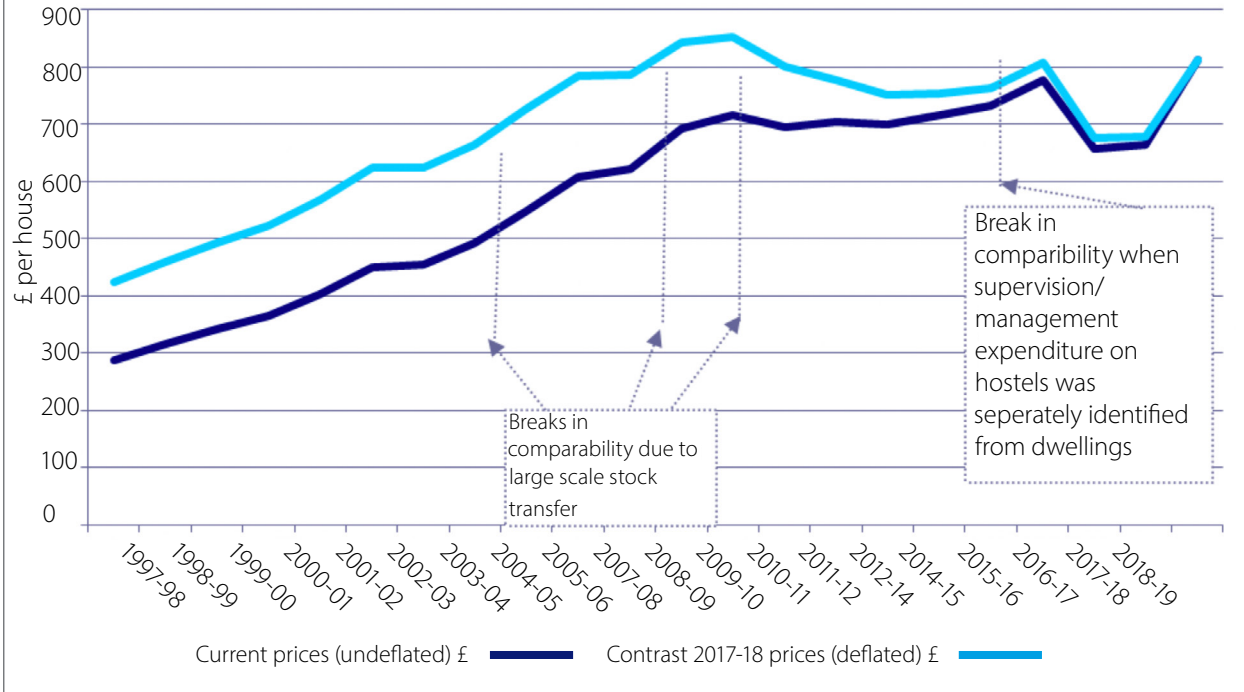
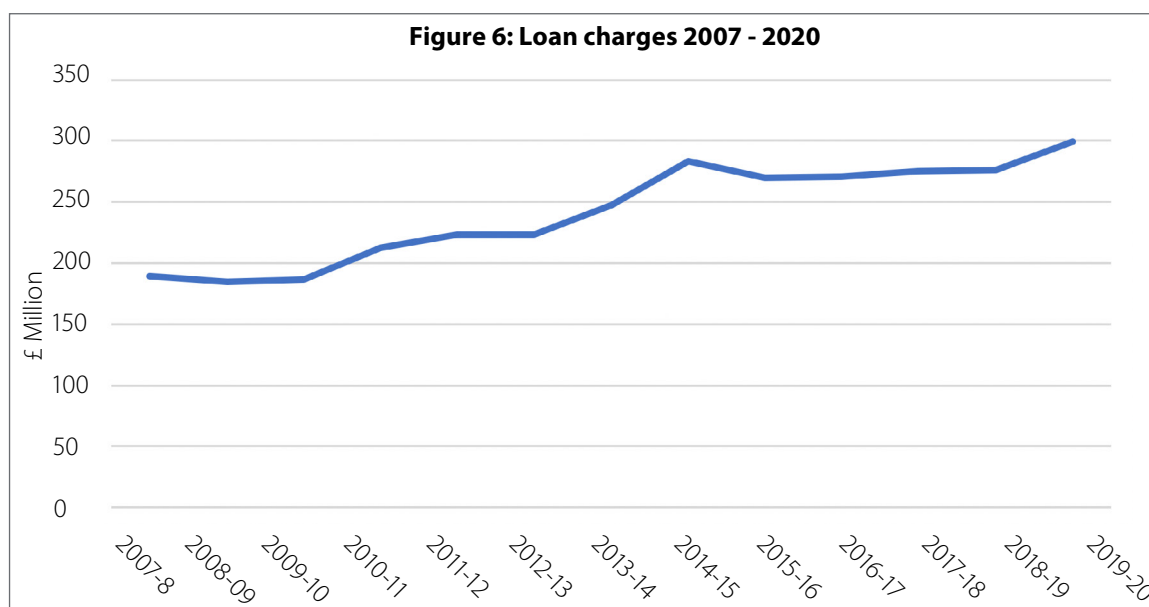
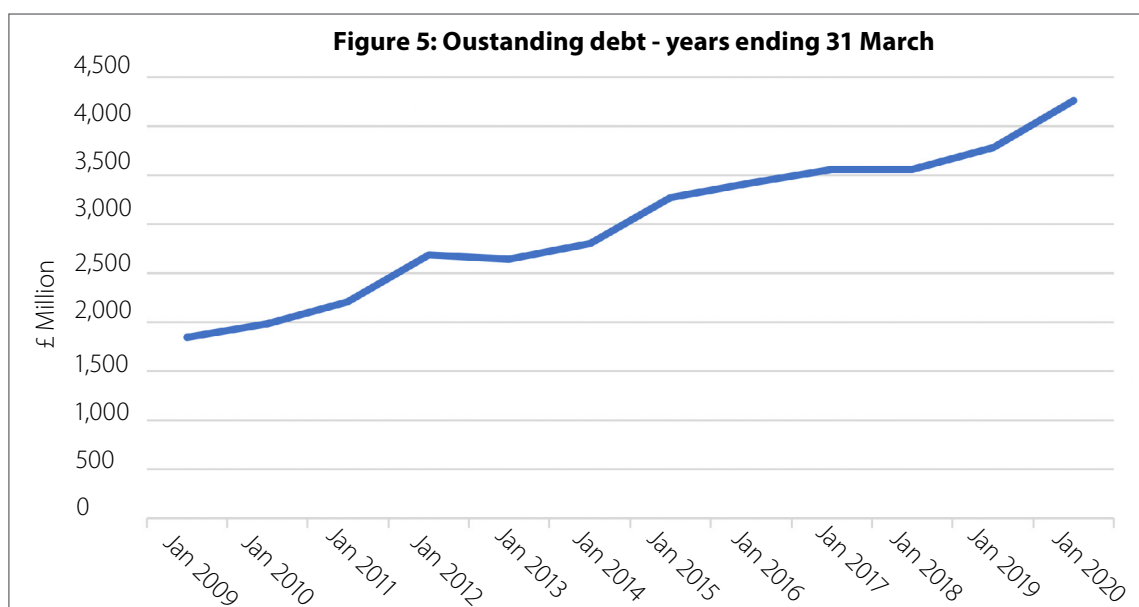


Figure 4: Repairs and maintenance expenditure per house, Scotland, 1997-98 to 2018-19



And whilst debt has risen significantly, debt costs have not, or at least not at anything like the rate of increase in total debt. This can be largely explained by a sustained fall in interest rates since the financial crash of 2007/8.

As seen below, debt has risen significantly (see figure 5), debt costs have not (see figure 6).



Overall, these figures suggest that Scottish local authorities have strong and largely improving finances. Stock numbers are rising for the first time in a generation and revenue costs are largely flat in real terms. The published figures show that rent arrears have risen from 4.06% of gross rental income in 2010 to 5.96% as at March 2019⁵ and provision for bad debt has more than doubled from around 1% of gross rent to 2.5%. But actual debt write-off has remained largely unchanged at 1% of standard rental income⁶ and lower than the 2009/10 figure of 1.3%⁷ suggesting that, despite the challenges of welfare reform, it has yet to have a significant impact on costs.

⁵ [Housing Revenue Account \(HRA\) statistics: Scottish local authority housing income and expenditure 2018-2019 \(actuals\) and 2019-2020 \(estimates\)](#) - table 17c

⁶ [Housing Revenue Account \(HRA\) statistics: Scottish local authority housing income and expenditure 2018-2019 \(actuals\) and 2019-2020 \(estimates\)](#) - table 20

⁷ [Housing Statistics for Scotland - dataset - local authority housing income & expenditure](#)

Regarding capital spending on the existing stock, investment per house has fallen in real terms by around 4.5%, probably reflecting the completion of the “first round” of major renewals to meet the Social Housing Quality Standard and EESSH. Investment adding to the stock (new and refurbished) has risen by over 150% from £114.8m in 2010/11 to a peak of £292.7m in 2017/18 and falling back slightly to £285.7m. in 2018/19. Councils are now delivering over 1,000 additional social rented homes a year.

These figures also suggest that in 2018/19, just 34.1% of investment in new homes came from Scottish Government grants. But the grant figures need to be treated with caution: three councils reported no grant income for their new supply programme (which does not seem very likely) and it isn't clear how TMDF (Transfer of Management Development Funding) resourcing for City of Edinburgh's and Glasgow City Council's investment programmes are reported in the tables. Some clarification on both points would be helpful.

The news isn't all good. Rents have risen by 12% in real terms since 2008/09. Figures since the middle of the decade suggest that increases have been broadly in line with CPI inflation. Despite this, income from all sources are down in real terms (this is the case for both house rental income and total income). So, whilst rents have been going up, a combination of right to buy sales and demolitions has meant that the total resources available to the sector have continued to decline over the past ten years.

One result of these trends is that HRA debt has risen significantly. Total debt held on the HRA was £3.552b (i.e. more than three times total income) at March 2018. This is up 78% since 2010. The rate of increase has, however, slowed significantly since 2015, growing just 8.4% between 2015 and 2018 (ie flat in real terms). Two councils have actually reduced their level of debt (Clackmannan and Shetland - though in the latter case this is largely the result of a specific arrangement agreed with the Holyrood and Westminster governments to address historic debt issues relating to the growth of the oil industry).

Somewhat counterintuitively, debt costs as a percentage of rental income are relatively steady varying between 24.1% to 24.4% between 2010-2016 and declining to 23.2% in 2017/18 (the most recent published figure). Whilst total debt has risen significantly, this does not appear to be of itself creating any significant upward pressure on rents.

This is likely to be linked to a steady decline in the “Pool Rate”⁸ of interest charged to the HRA. The notional “average” pool rate across the 26 stock holding councils has fallen from 5.79% in 2009 to 3.8% in 2018 but current rates locally vary significantly from 5.19% to 3.07%.⁹

The most significant change over the past decade or so, arguably, has been a considerable rise in the gross “national” surplus. Calculated after debt costs, this has gone up from £142m in 2010/11 to £236m in 2017/18. A rise of just over 49.2%, that is 21% ahead the rate of CPI inflation over the same period. And whilst this figure is estimated to fall by 6.3% to £221m by the end of the 2018/19 financial year, the national “surplus” will still have risen 37% ahead of inflation in less than a decade.

This headline figure in particular masks significant variations between Councils in terms of both the financial strength of the local HRA and the business plan strategies that have been adopted. Three Councils undertook no additional borrowing at all in 2017/18. Angus in particular funded 64% of its investment programme from its revenue surplus (CFCR).¹⁰ Three Councils generated no surplus and drew down reserves to balance the books whilst two others made significant contributions into their reserve fund. Overall, a dozen Councils saw their reserves grow though only in four cases was this increase significantly over £500,000. Two Councils committed the whole of their surplus to reserves presumably to support future investment. Interestingly, two Councils reported making a contribution to their general fund whilst a further two reported funds flowing from the general fund to the HRA.

⁸ The convention in local authorities is that interest on HRA borrowing is charged at a rate calculated as the average across the Councils whole debt portfolio. This is known as The Pool Rate and is higher than the Public Works Loans Board “spot” rate, that is, the actual interest charge to the Council at the point when the funding is drawn down.

⁹ Note that the use of the pool rate is why we have not had much reaction from the council housing world in Scotland to the recent increase in PWLB (Public Works Loan Board) rates.

¹⁰ Generally referred to as Capital Funded from Current Revenue (CFCR)

Implications

Drawing conclusions from these figures is far from straightforward. At an aggregate level, local authority housing finance looks healthy, stock numbers are rising, costs are under control, debt is well within prudential limits both as a multiple of total income and as a percentage of rent, and rising rent areas are not, as yet, putting pressure on rents.

One conclusion could be that the current five-year period is starting to look like a transition period from 2010-15 where rents, investment, debt and the surplus rose rapidly. Over the past two/three years these trends have all started to flatten out as the sector has largely completed the investment required to meet the SHQS and EESSH. The long-term decline in local pool rates has also been a factor in supporting new borrowing and investment.

The ending of the right to buy and the return to building/buying homes by the sector also strongly impacts the figures around stock and debt cost but does not seem to have driven rents directly. There is clearly a link between CFCR, debt costs and rents - with Councils adopting one of a number of business plan strategies to support investment including, in a number of cases, apparently, pushing up surpluses to fund new investment whilst keeping borrowing to a minimum.

Business plan strategies aside, these figures also provide the basis for a reassessment of the overall capacity of the sector to grow the stock. Looking specifically at "Interest Cover Ratio" (ICR): defined as turnover minus operating cost (excluding debt) divided by interest charges,¹¹ we can make some attempt to assess the sector wide capacity to carry higher debt costs.

Derived from the HRA data, the current ICR for the notional Scottish HRA is in the order of 3.423. The study cited above (see footnote 8) suggests an equivalent figure for England and Wales as 1.93 and goes on to indicate that 1.5 can be regarded as a "prudent" ICR.

Taking this as a benchmark and making reasonable assumptions¹² about term length and borrowing charges, implies a capacity potential of around £6.38 billion. If grant rates were to continue at 30%, this would imply a forward programme of £8.92 billion. At an average cost of £150,000 per unit this implies a programme (over multiple parliaments) of more than 55,000 new homes. These are assumption-driven, 'back of an envelope' calculations but are worth exploring further, in particular the implications for rents. However, it is interesting to note that in early 2020, these numbers are not too far away from the financial capacity numbers proposed in 2010 by the then controversial Bramley, et al, study.¹³

What's not clear is if the same level of investment could be achieved with higher borrowing and lower CFCR (and rents). Equally, those councils that started the process with lower levels of surplus and higher borrowing have faced a more challenging task to keep rents low and increase investment. More broadly, it is worth surely having a wider debate about the costs and benefits of shifting this surplus v borrowing trade-off, when we consider the optimal way for specific councils to fund investment in new supply.

In terms of what would make a difference going forward we conclude with three main points:

First, a shift to the PWLB spot rate can reduce the denominator in the ICR. To do so would make a significant difference (at least a 1% reduction in interest rate) for 7 Councils with a further 20 making at least a .5% cost reduction. This option is considerably more attractive now that the 1% surcharge applied by the Treasury during 2019 has been removed in the March 2020 UK Budget¹⁴.

¹¹ Social Housing, [Special report: latest council HRAs show sector is ripe for investment](#)

¹² Assuming borrowing over 30 years on a repayment basis at the current "average" pool rate.

¹³ Bramley, G, Pawson, H Morgan, J, Wilcox, S and Williams, P (2010), [A Study Into the Capacity of Registered Social Landlords and Local Authorities to Build Housing Across Scotland](#)

¹⁴ [Inside Housing budget 2020 coverage](#)

Second, as a result of everything discussed here, it is clear that we urgently need some strategic forensic research on council housing HRA business planning, as well as a more transparent debate on the choices made regarding the mix of funding for new investment (given the sensitivity of rent increases).

We would, third, stress the evidence of considerable local variations that are often quite significant. We don't have the space here to dig into this more, and whilst we would be cautious in drawing too many very specific conclusions on local options and approaches from these high level figures, it is clear that in the long term a significant stock of well managed social rented homes is capable not only of covering its own day to day costs but could do so at genuinely affordable rents.

How the cost of new supply is shared between existing tenants and the taxpayer should perhaps be the subject of a different discussion.

About the authors

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