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Why councils are underinvesting in housing and how an updated debt settlement could put that right

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Executive summary

This report by the Chartered Institute of Housing (CIH) in partnership with Savills looks at how an updated debt settlement could revitalise council housing finances and create greater capacity for local authorities to provide good quality homes and meet new housing needs. It is crucial to note that updating the debt settlement must work as part of a package of changes in order to provide stability to local authority finances and capacity, with this report focusing on one aspect of such a package.

In 2012, the government and local authorities agreed a self-financing settlement, aimed at making Housing Revenue Accounts (HRAs) sustainable and allowing for growth and investment. But the assumptions made then no longer fit with the financial and policy environment as it has evolved since 2012. The impact of rent controls, sustained higher-than-expected inflation, loss of stock through right to buy, and new regulatory burdens have all undermined the original settlement. The result is that councils have unsustainable debt levels and there is simply not enough money in the system to allow council housing to be run properly.

We consider several ways in which additional money can be brought into council housing, including a completely new HRA settlement. However, analysis of potential options indicates that revising the original debt settlement is the best course of action. Such a revision was allowed for in the terms agreed in 2012.

This revision can be done by amending the original parameters of the settlement, updating key components to reflect the significant policy changes and events that have undermined the assumptions made in 2012. The report calculates the financial effects of:

- Restrictions on rent policy
- Major changes in the operating environment
- Rising additional costs
- Changes in right to buy discounts (hence higher sales volumes).

A proviso to its calculation is that more work is required to assess the cost to councils of achieving the government's net zero carbon objectives. The report provides a high-level analysis of the potential impact of updating the debt settlement at a national level, with an understanding that the potential results must be calculated for each individual local authority, and its effectiveness is dependent upon the wider context of policy decision-making.

We show how the settlement could be brought up to date in six steps. These lead to a calculation that the sustainable level of debt for local authorities with HRAs to deliver against current and potential future quality and regulatory standards is now estimated to be around £11 billion. This compares with debt of approximately £29 billion in the original settlement (or about £0.5 billion lower than this if an adjustment is made to reflect the smaller number of councils now with HRAs).

Transferring the estimate of unsustainable debt of £17 billion from local authorities to central government would mean that council housing finances could again be given the opportunity to become sustainable for the long term, as was the goal in 2012. It would create headroom for investment in the stock and recreate the capacity to build new homes that existed in 2012. Extra investment will also create income through other means, such as additional VAT, which would partly offset the additional government costs.

Crucially, revising the existing debt settlement ensures that the homes of 1.6 million tenant households remain at affordable rent levels, by securing council housing finances over the long term.

Introduction

Local authorities in England need to build more homes and invest more in their existing housing stock. But they are unable to invest at the required scale because of insufficient capacity in their HRAs. The 2012 self-financing debt settlement was intended to leave HRAs on a sound footing and facilitate further investment, but it has been eroded by subsequent events and policy interventions. This briefing paper considers how the settlement could be reconfigured and updated.

The paper briefly outlines the background to the settlement and the significant changes that have impacted upon its effectiveness. It notes the potential alternative ways to bring more resources into HRAs and concludes that an updated settlement has distinct advantages over other options. The remainder of the paper considers how this might be undertaken and what effects it would have.

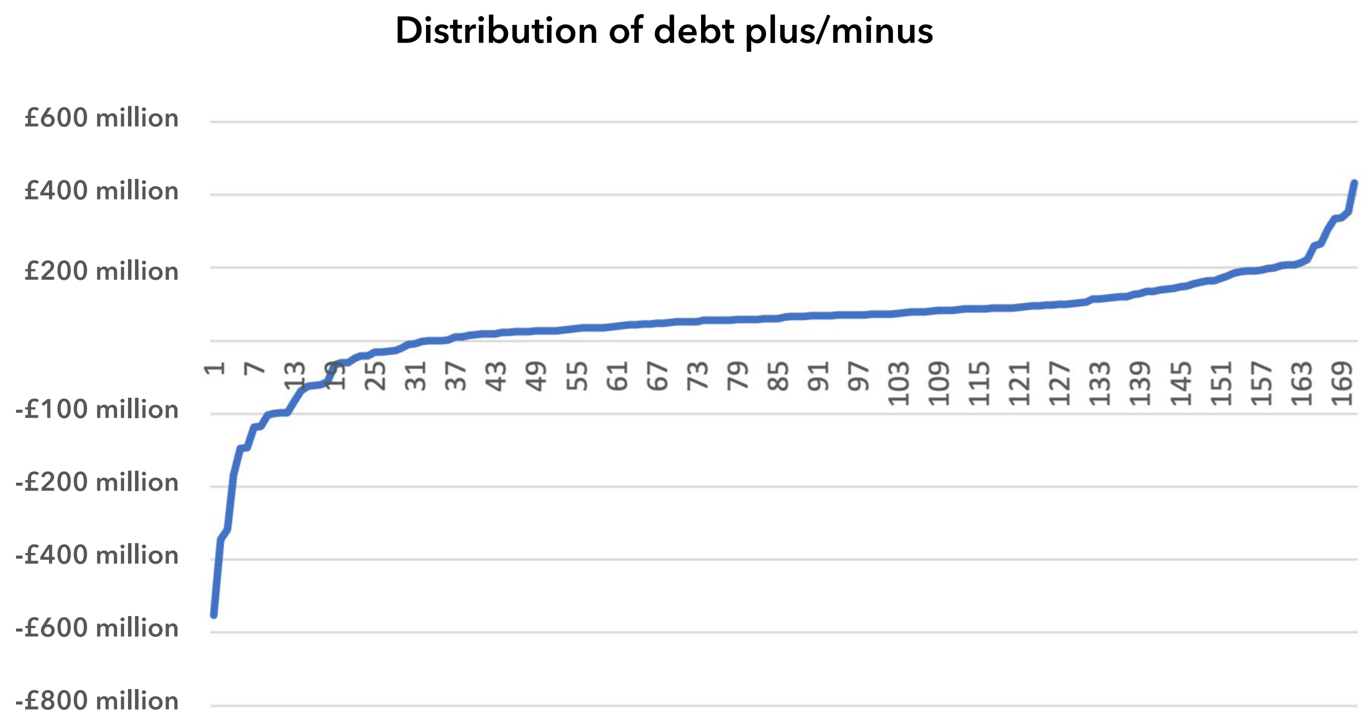
The 2012 debt settlement

Until 2012 HRAs were subject to a significant degree of central government control, under the HRA subsidy system that derived from the Local Government and Housing Act 1989. This largely aimed to ensure surpluses from council housing could not finance extensive borrowing and captured a proportion of them for central government. By 2012, many authorities experiencing 'negative subsidy' had already transferred their stock to housing associations, in part to avoid these losses.

The 2012 debt settlement was intended to ensure that HRAs were sustainable in the long term, based on net rental income and without any further subsidy payments to or from central government. Surpluses could be used towards improving services, new build or stock improvements, and the settlement was essentially predicated upon maintenance of the stock at the Decent Homes Standard (DHS). To avoid rental surpluses being used to finance extensive new borrowing, the settlement initially included a cap on each council's HRA debt, although this was abolished in 2018.

A key component of the 2012 settlement, brought into effect by the Localism Act 2011, was the level of debt held to be sustainable for each local authority. Collectively, councils took on £13 billion of additional debt (£8 billion in net terms, since 33 councils had debt written off – see Figure 1). The agreed debt figure was based on assumptions about future rental income, inflation, and stock investment requirements. The extra debt financed one-off payments to the Treasury to compensate it for the loss of negative subsidy.

Figure 1: Distribution of HRA debt to local authorities, resulting from the 2012 settlement



It was accepted that significant public policy changes could impact these assumptions and provision was made within the Act to reopen the settlement if any such changes had a material effect on the ability of authorities to meet their needs. This report looks at how the debt settlement can be reconfigured, based on assessing what has changed since 2012 and why the original settlement no longer works.

Why the settlement no longer works

The initial settlement was largely positive for local authorities. However, there have been significant changes since 2012 on a national scale which have undermined its effectiveness.

Major changes in the operating environment

Macroeconomic conditions since 2012 have drastically changed, with higher inflation, including rising costs of labour, materials and energy, the broader cost of living crisis, and additional pressures following the Covid-19 pandemic. This volatility has meant that the sector has faced immense financial pressure, with local authorities warning that "systemic underfunding" coupled with increasing demand for services and rising costs could lead to further Section 114 notices (which indicate potential bankruptcy and have, so far, only been based on potential defaults in councils' General Funds, not their HRAs).

Rising additional costs

The DHS was intended to be achieved by 2010; the settlement worked on this assumption, only allowing additional funding for some authorities with arms-length management organisations (ALMOs) that were completing their DHS programmes. This meant that there was no provision for further stock improvements beyond the DHS. However, cost increases have meant that significant additional costs are required to achieve and maintain the DHS. The Regulator of Social Housing (RSH) found that headline social housing costs per unit increased by 14 per cent to £4,586 per unit in the financial year to March 2023. This was largely driven by rising costs of materials and building safety obligations, which apply to all social housing providers, including local authorities.

The Building Safety Act 2022 introduced additional requirements for fire and building safety cases, which the Local Government Association (LGA) estimates to cost an additional £7.7 billion for councils nationally from 2023 to 2030. There are also new requirements for energy efficiency, damp and mould works, as well as expected future costs for the update of the DHS and proposals set out in consultations on Awaab's Law, the Future Homes Standard and movement towards achieving net zero targets, the introduction of enhanced regulation via the revised Consumer Standards under the Social Housing (Regulation) Act 2023 and the Competence and Conduct Standard.

Right to buy

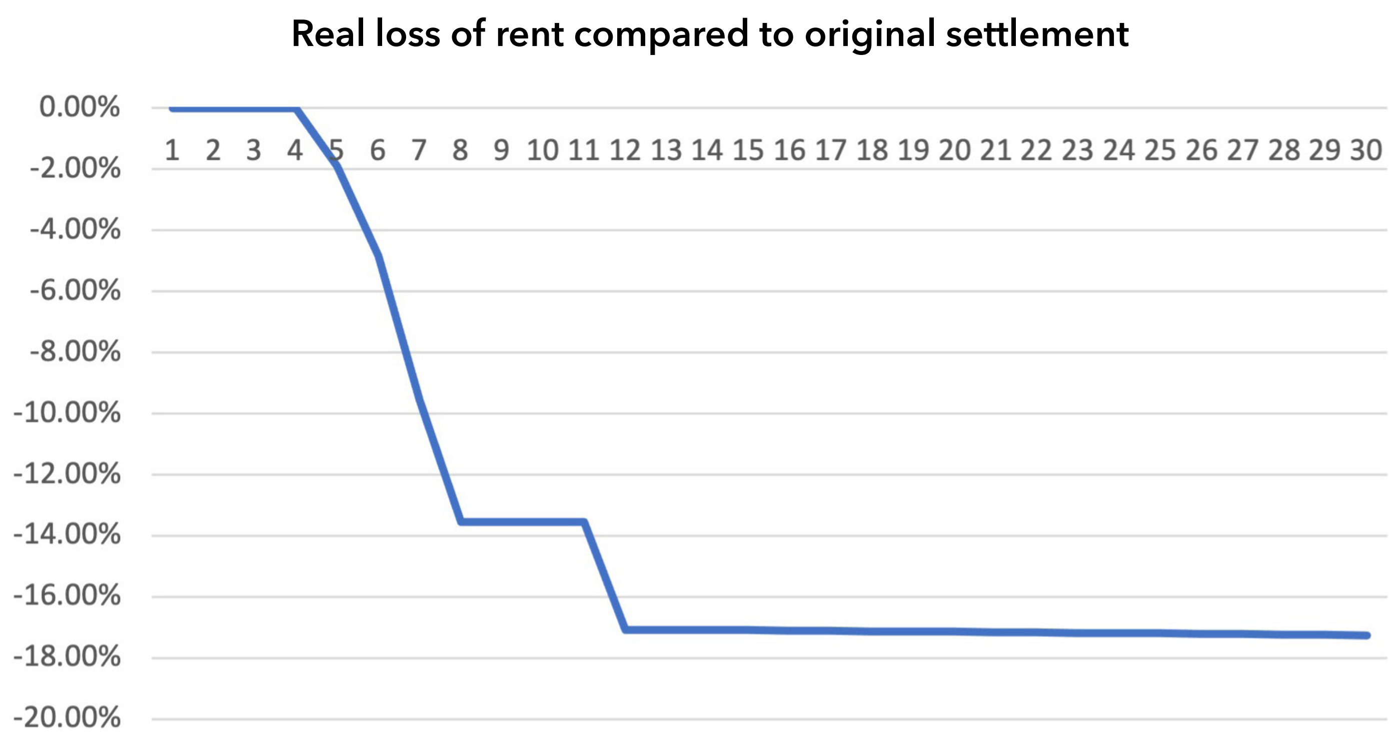
The settlement also made an assumption on the loss of income resulting from right to buy sales, but this took no account of the 'revitalised' right to buy, launched at the same time in 2012. The maximum discount was raised to £75,000 (£100,000 in London) and has increased subsequently. Volumes of sales significantly increased, with the LGA estimating that £7.5 billion in discounts have been handed out since 2012, with insufficient replacement of these lost homes. Local authorities have been restricted in the retention and reuse of receipts from sales, which has further impacted income.

Rent policy

In addition to increased costs, large net real-terms reductions in HRA income have resulted from changes in national rent policy. The settlement was based on increases at RPI plus 0.5 per cent. In 2013, a new settlement was announced based on the Consumer Price Index (CPI) plus one per cent for 10 years from 2015-16. However, this was almost immediately undermined by rent reductions from 2016 of one per cent each year for four years. The return to the previous CPI settlement from 2020 was followed by a new cap on increases of seven per cent for 2023-24 before a return to CPI plus one (7.7) per cent for 2024-25. The original period of the 10-year CPI policy ends in 2025, but the previous government announced a rollover of the settlement for one year only to March 2026 at CPI plus one per cent.

The loss of rent income since 2015-16, compared to the original settlement (see Figure 2), is the biggest component of the reduction in HRA resources, and represents a very significant withdrawal of resources from the HRA system, cumulatively over 17 per cent compared to 2015-16 levels in real terms, which is now being felt in every HRA as cost pressures are biting.

Figure 2: Real loss of rental income compared to the original settlement



What are the options to put it right?

The basic problem created by the erosion of the 2012 settlement is that HRAs are now under-resourced compared to the position they would have been in, had the terms of the initial settlement been followed by the government since then. How do we close the gap?

If the objective is to restore every HRA to the position it should have been in, in 2024, there are five ways to put the required resources into HRAs:

- Revenue subsidy – restart a version of the revenue subsidy system that applied pre-settlement
- Capital subsidy – offer capital grant, likely linked to specific work such as building safety or achieving zero carbon
- Allow future rent increases to exceed inflation by the margins required to restore HRA income to the expected levels
- Undertake a completely new HRA settlement
- Revise and update the original HRA settlement.

Here we briefly consider each of these options and explain why the last one (a revised settlement) is the recommended course of action.

Revenue subsidy

In principle, a new version of HRA subsidy could be devised, possibly based on covering the debt charges on the proportion of each council's HRA debt that exceeds the level anticipated by the original settlement, or alternatively as a new 'major repairs allowance'. However, there are at least four reasons why neither central nor local government are likely to want such an approach:

- It would revive some of the worst and most disliked aspects of the old system
- It would be very complicated to devise an allocation system that would be fair to all local authorities, and national government fiscal policy has moved away from detailed redistributive financial systems
- It would almost certainly require a new, regular (probably annual) settlement process, with the workload and uncertainty this implies
- It would, in effect, restore detailed central government control over HRAs, which the settlement was intended to bring to an end.

Capital grants

While capital grants have a role in the current system for fundamental policy priorities (e.g. in new build and decarbonisation), their more widespread use would raise questions about the mechanisms to be used. Employing grants with a competitive bidding process is neither efficient nor appropriate as a means to support ongoing maintenance and investment and is wasteful if every authority has a need to achieve these higher standards. It is difficult to see how a comprehensive scheme of capital grants could be devised which would address the scale of the gap that has resulted from erosion of the original HRA settlement. It would also restore central government control over an important aspect of HRA financing, contrary to the intentions of the settlement.

Above-inflation rent increases

In theory it would be possible to change rent policy to allow rents to increase faster and to a higher level – but there would be extra costs in terms of increased benefits payments and risks in terms of social rents beginning to approach or exceed market rents if this was pursued over an extended period. Some opposition from tenants and councillors could be expected and would need to be faced.

New HRA settlement

A new settlement would take HRAs back to square one, with a new assessment of debt and resource needs that would repeat the exercise conducted prior to the 2012 settlement on a fresh basis. That exercise took around three years, spanned two separate governments, and required an intensive period of negotiation with authorities. Given that this would be a repeat of the earlier exercise, a new one might be quicker, but it would still be a major task as new sets of assumptions would need to be agreed about income, investment needs and other issues, applying both to the starting point (in 2025-26 or whenever) and to the subsequent 30-year period.

A new settlement would result in a new assessment of the debt burden, with a new 'start date' when councils would either take on new debt or, probably in all cases, transfer designated amounts of existing debt to central government (as happened in April 2012).

Revised and updated HRA settlement

This approach would assume that the basic parameters of the 2012 settlement are still valid, but the values attaching to them need updating in the light of subsequent developments – in rents policy, in particular, but also in factors such as standards to be met in the existing stock, excessive and systemic cost inflation, supply chain pressures, enhanced regulation and unanticipated stock losses due to the revitalised right to buy.

The advantage of this option compared with the previous one is that all the parameters are already in place and the exercise is the simpler one of attaching new values to them.
The 2012 settlement allowed for such a revision in changed circumstances.

Note that in all private finance deals (leases, funding and investment) there is usually a "change in law" provision that allows investment and returns to be revisited when standards change – no investor would contemplate investment without such a clause, hence the legitimacy of a revision to the settlement to take account of these changes.

Work by Savills for London Councils looked at the scope for a revised settlement in London, and this proposal is now promoted by the London Housing Delivery Taskforce.
As in the previous option, there would be a day when every individual HRA's debt levels would be adjusted downwards, with the excess debt transferring to the Treasury.


Conclusion – the recommended approach and its implications

The recommended approach is the fifth option – reopening the old settlement – as it would be simpler and quicker than an entirely new settlement, while retaining the original objective of making HRAs self-financing, keeping them at arm's length from central government and maintaining rent increases at affordable levels for tenants.

In financial terms, reopening the old settlement is roughly equivalent to devising and implementing a new HRA subsidy system, but with the important difference that it is a one-off settlement, not an ongoing, annual exercise. In accounting terms, it has a lower impact on central government finances than capital grant would have, since there is no new debt (just a debt transfer), while the revenue costs are the same or similar.

The cost to central government of a revised settlement arises from the cost to the taxpayer of the transferred debt. However, given that local authorities' spending power would be improved, from not having to use so much rental income to sustain debt, they are likely to direct this into capital investment or major repairs, generating additional income for central government via income tax, VAT, etc. This would partly offset central government's additional debt servicing costs. In fiscal terms, a new settlement would not be unlike the fiscal effects of the scrapping of the HRA borrowing caps in 2018. This was estimated by the Office of Budget Responsibility (OBR) to add up to £1.2 billion to capital spending by 2023-24; the OBR also estimated the beneficial effects on the economy of new housebuilding resulting from LAs' extra borrowing capacity. It might be expected that the OBR would undertake a similar assessment of the likely results of a revised HRA settlement.

Finally, giving local authorities renewed power over their HRA resources would reinforce devolution aims and ideals, with the added flexibility and freedom helping to ensure that local needs can be met.

HRA self-financing debt settlement: Steps in a possible revision

We propose that a revised debt settlement could be calculated in six steps, as follows.

Step one: Changes in number of authorities

The first step would be to amend the original settlement for changes in numbers of authorities, as some have transferred their stock, and the progress of local government reform has led to the merging of some HRAs. This would reduce the number from an original 169 to a current 158 (excluding two authorities with PFI stock and one – the Isles of Scilly – with zero debt). The original settlement's total debt of £29.188 billion would fall to £28.685 billion at 31 March 2024. This reduction of £0.503 billion would represent the revised "starting point" for refreshing the settlement.

Step two: Effects of rent policy changes

The second step would amend the original settlement for the changes in rent policy over the period 2012-2024, summarised above. The recast settlement (see step one) is £28.685 billion; the reduction in rents as a result of real changes in allowed increases from 2016-2024 is £10.184 billion, meaning that the settlement is cut to £18.501 billion. Note that if there were no further real increases in rents beyond 2025 (i.e. CPI only increases in future), this would reduce the settlement by a further £1.06 billion.

Step three: Changes in standards

The third step would amend the settlement to take account of changes in standards since 2012. Work undertaken by Savills in relation to increased costs of meeting a higher energy-efficiency standard (EPC band C) and meeting new fire and building safety requirements suggests a national average unit total of approximately £5,000 per unit applied between 2020-2030. Detailed work would be required to determine the impact locally. A broad estimate of the cost of DHS2 (a revised Decent Homes Standard) would be an additional 10 per cent - though this remains speculative until the revised standard is published.

The "starting point" settlement would fall by £4.535 billion in this step of the calculation. The application of this 16 per cent debt reduction nationally would vary widely between authorities given the different numbers and proportions of tall buildings in local authority stocks.

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Step four: Excess inflation

The fourth step would amend the settlement for excess inflation in the period 2020-2024. We consider it appropriate to reflect a one-off increase in capital repairs inflation to take account of the difference between Building Cost Information Service data for repairs and CPI over this period, of 10 per cent, together with a one-off five per cent increase to capital costs from supply-chain pressures.

The "starting point" settlement would fall by £1.555 billion due to this step in the calculation. This reduction in debt would likely apply differentially for those with higher capital repairs costs due to the nature of stock (high rise, flats, etc.).

Step five: Additional regulatory pressures

This step would adjust the original settlement for higher regulatory burdens and pressures from 2023-24, as noted above. To model the potential impact of these additional pressures, we have applied a five per cent increase to management costs (additional professionalisation costs, additional officers to deliver effective additional governance and accountability assurance to senior officers and members) and a five per cent increase to revenue repairs costs (reflecting the potential for Awaab's Law cost pressures consulted upon in early 2024). This results in a reduction in the settlement of £0.932 billion.

Step six: Property losses

The final step is to amend the settlement for higher property losses between 2012 and 2024. The property numbers in the settlement relating to 2023-24 were 1,604,000, but actual numbers are now 1,564,000 – a reduction of approximately 40,000 or 2.56 per cent more than provided for in the settlement. The lower numbers still must sustain the same level of debt as provided for in 2012.

The difference would provide for a further reduction against the settlement of 2.12 per cent; if this were applied to the original settlement, this would be £607 million. However, we consider it more appropriate to apply steps one to five first, and then apply the stock reduction. This results in a reduction of £228 million.

A revised settlement

A revised settlement calculated on this basis would (in summary) be as follows:

	£ (Million)	% Age reduction
Original settlement	**29,188**	
Revision for authority numbers	-503	
Recast original settlement	**28,685**	
Revision to rent policy	-10,184	36%
Revision for standards	-4,535	16%
Revision for capital repairs inflation	-1,555	5%
Revision for regulatory pressures	-0.932	3%
Revision for property numbers	-0.228	1%
Speculative consolidated revised settlement	**11,251**	

Revisiting the 2012 debt settlement for the factors identified implies a reduction in debt of approximately 61 per cent overall – a debt write-down of £17.434 billion.

A modified option, combining two of the five different approaches discussed briefly in the introductory sections, would be to support the additional cost elements (with the exception of the repairs inflation) via capital subsidy. This would produce a hybrid solution, based partly on a revised settlement and partly on additional capital grant.

Whilst we can argue that for rents, inflation, regulatory burdens and DHS2, the additional revised values would be more or less uniform across all HRAs, there would need to be an assessment of the differential impact of fire/building safety spending depending on the number of tall buildings, and buildings for vulnerable residents. As a result, some authorities would see a higher-than-average relative write-down. However, the largest impact is due to rents, and this applies proportionately and evenly to each authority.

All figures should be treated as a guide for discussion only. However, the rent and property number elements of the calculation are substantiated via robust national data and would not necessarily require any re-analysis of detailed cost liabilities locally. Further work would be required on costs, however, to arrive at a robust methodology should this become a policy option.

Finally, we reiterate a point made at the outset that a revised debt settlement is only one of the reforms required and our analysis focuses on this, primarily in relation to the needs of the existing stock. Work by CIH and others looks at other issues such as providing new social rented homes, rent policy, reforming the right to buy, the new DHS, etc., which are not covered here.

Note: Further detail on the calculations in steps one to six above can be found here.
For further information contact: policyandpractice@cih.org

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