

1. Aim of This Guide

- 1.1 This guide sets out the basics of how regeneration projects are financed when change of tenure is involved. It will also explain how we will assess the regeneration proposals from the finance point of view. Other papers appended provide more background reading on the subject of housing finance in Scotland.
- 1.2 We know that money comes in from rents, but sometimes money comes in through subsidies as well. For major projects money is often borrowed.
- 1.3 While money is spent on repairs and running the housing service, substantial sums are also needed to pay for borrowing for purchase, improvement or new building. Things therefore begin to get complicated.
- 1.4 In a project area, the council will typically sell some or all of the land and houses. After regeneration, there is usually a mixture of rented and owner occupied housing. Some or all of the rented houses will belong to a different landlord. The houses could be a mixture of refurbished and newly built houses following some demolition, although this can vary.

2. The basics of Income and Expenditure

- 2.1 Let's start with the financing of a landlord's housing operation.
- 2.2 Income towards the cost of running the housing service of a landlord comes mainly from
 - rents
 - right to buy sales, if any
 - subsidy
 - borrowing money from banks, etc.
- 2.3 Expenditure has to cover the following main costs.

- purchase of houses/land
- repaying loans gradually
- housing management (staff, offices, etc.)
- day to day repairs
- cyclical maintenance
- planned maintenance
- improvements

2.4 From year to year, landlords have to balance their “books”.

3. Income

3.1 Rent is the biggest source of regular income. Landlords have to allow for some potential rent income being lost through rent arrears never recovered and when houses are empty awaiting relet.

3.2 Housing Benefit is not a direct subsidy to landlords. It is a subsidy personal to those tenants qualifying after a means test. In the list in section 2, housing benefit is part of the rent income and therefore not listed separately.

3.3 After regeneration, any tenants who transferred from the Council to the new landlord while remaining in the same house will continue to qualify for the right to buy. Should some tenants exercise this right, the new landlord will receive the income from sale, but will no longer collect rent from the sold house.

3.4 Subsidy is complicated in regeneration and is covered briefly later in this paper.

3.5 Because purchase of property, building and refurbishing houses is so expensive, but also lasts a long time, landlords borrow money to do these things. Repayment of loans takes place over a very long time.

4. Expenditure

4.1 Loan charges include repayment of the capital sum borrowed along with the interest payments on the outstanding capital debt. Interest repayments can vary depending on the level of interest rates in the economy generally.

4.2 Loan charges can take up from one third to two thirds of the rent income.

- 4.3 Housing management includes the cost of paying staff to deliver a service along with the offices they use and their overheads. These costs usually require no more than a fifth of the rent income.
- 4.4 Day to day repairs are the repairs done mainly in response to tenants reporting them. These costs can vary depending on the age and condition of the houses.
- 4.5 Cyclical maintenance costs cover routine work like servicing gas boilers, repainting external woodwork, landscaping maintenance, and so on.
- 4.6 Planned maintenance means the replacement from time to time of the major components of the houses, e.g. heating systems, kitchens, bathrooms, guttering, windows and so on.
- 4.7 In housing finance, the strict meaning of the word “improvements” is adding something new which upgrades the property. This distinguishes it from planned maintenance. For example, replacing an obsolete heating system is planned maintenance, while installing a heating system for the first time is considered an improvement. Adding insulation to poorly insulated walls would also be regarded as an improvement.

5. Subsidy

- 5.1 Let’s consider why subsidy is required. These days building a new house may cost anything between £45,000 and £70,000 depending on size, type and quality. A decent average sized house may cost around £60,000 including the cost of the land it sits on. The money to build a house for rent has to be borrowed. The yearly loan charges on such borrowing could amount to around £5,500. Your annual rent may be somewhere between £1,800 and £2,300 per year at present. This has not only to contribute to loan charges, but also pay for repairs and housing management. You can see it is nowhere near enough to repay the costs of building a new house.
- 5.2 Refurbishing existing housing may cost anything up to £60,000. This depends on the scale of refurbishment. If say, a refurbishment costs £40,000 per house, the loan charges would be over £3,000 a year. This is still considerably more than an average rent.

- 5.3 While some increase in rents is likely after regeneration, it will be nothing like what is needed to pay for building or refurbishing work. Hence the need for subsidy. It is possible for you to have a say in rent levels after regeneration. You may find yourselves balancing out the quality of housing versus rent levels. You will want to see that subsidy is sufficient so that you can have good quality housing within an affordable rent.
- 5.4 The problem is subsidy is difficult to obtain. In regeneration projects subsidy can come from three main sources.
- 5.5 The first possible source is from Government. This could come through Scottish Homes, a Government agency. Scottish Homes has many competing demands for the subsidy it distributes. It cannot hope to meet all the demands. The Government may also allocate additional consent to borrow money or provide subsidy by other means as a special allocation to councils for new Housing partnership projects.
- 5.6 The second possibility comes from the council being willing to sell the land and houses within the project area extremely cheaply. The council will have outstanding debts to continue paying for the original building of the existing houses and any major improvement work it has carried out. Much of this debt could fall to remaining council tenants to continue repaying from their rents. The council has to make a judgement about how cheaply it is willing to sell the land and houses to help the project, while keeping in mind the interests of remaining tenants and the debt burden it is passing to them. Councils may seek subsidy from Government to help them deal with this problem of outstanding debt.
- 5.7 The third possibility for subsidy comes from switching a part of the income from houses in the project area sold to owner occupiers. This subsidy depends partly on selling for prices higher than the combined land purchase and building costs. Most of this difference is usually the value of the land the houses sit on. Subsidy from the owner occupied houses built also depends on the total numbers of houses for sale compared to the number for rent. In any project, the challenge will be to provide sufficient surplus from sales to owner occupiers while still providing enough houses for rent in the project area.
- 5.8 The key aspect to understand about subsidy is that it must be sufficient now to ensure that the loan charges which have to be met from tenants' rents can be met now and in the future.

6. Cash Flows

- 6.1 The new landlord will have to make long term financial plans. They are needed to show that renting the houses is a viable proposition long term. As tenants, you need to know the kinds of rents you will be expected to pay in the future and what you will get for your rent. The bank doing the lending will need to know that the loans it gives can be repaid. The financial plans have to show the various costs from year to year including future forecasts of how much should be spent on planned maintenance. All parties have to be confident that there are sufficient funds, when needed, to look after the houses properly.
- 6.2 Planned maintenance estimates are made by a surveying firm calculating how long the major house components will last, costing what it would be to replace them and budgeting for this cost at the right time in the future. Costs like this are often called *life cycle costings*.
- 6.3 The new landlord will make financial plans for a 30 year period. They are often called *cash flows*. Two main cash flows are usually produced. One shows how much can be paid for the houses at the start. A second one includes the estimated cost of repaying loans. This second one also has to make assumptions about inflation rates in the future.
- 6.4 Financial planning like this is not an exact science. To check the effect of variations on the main future costs assumed, extra calculations have to be done. Some variation has to be possible without endangering the viability of the financial plan.

7. Assessing the Financial Plans

- 7.1 Tenants require independent advisers to carry out assessments of the proposals put forward by developers or potential new landlords. These assessments include examination of the financial plans in some detail.
- 7.2 All the factors described already have to be included in the assessment.
- 7.3 The costs of refurbishment depend on the scale of work undertaken. It will be cheaper than new build and so will require less subsidy. Building as many new houses as possible may be

more expensive but may give the best housing conditions. The mix of sizes of the new houses will affect their cost.

7.4 When constructing their proposals, the proposers will have to balance the following main aspects:

- how many houses can be provided (new or refurbished)?
- what quality of refurbishment or new build can be financed?
- what mix of refurbishment and new building can be financed?
- how many owner occupied houses are needed to provide enough subsidy to the rented houses?
- can any targets for the number of rented houses be met?
- how much can the owner occupied houses fetch?
- how much will the Council be willing to accept for selling the area?
- what future rent levels will be acceptable to tenants?

Your independent advisers will assess judgements made on all of those aspects. The only people that can judge the acceptability of future rent levels is yourselves and other tenants. Your independent advisers should be able to advise on possible variations to the proposals to best meet your interests.

Alongside that assessment, independent advisers must study the cash flows in detail and report on the estimates of income and expenditure shown and what this will mean for you.

The range of aspects includes:

- projections about rent levels in the future
- rent loss predicted through irrecoverable arrears and casual vacancies
- service charges, if any

- estimates of income from future right to buy sales, if appropriate
- the loan charges which have to be met from rents in the future
- the costs assumed for housing management
- the costs allowed for future repairs and maintenance
- the costs and timing of planned maintenance.

In doing this your advisers should draw to your attention, in a factual way, issues that arise from the assessment and the conclusions they reach.