

## **SOUTH KESTEVEN DISTRICT COUNCIL**

### **LOCAL AUTHORITY MORTGAGE SCHEME (LAMS) POLICY**

#### **1. Introduction**

Currently, home mortgage lenders are typically prepared to lend a maximum of 75-80% loan to value (LTV), even if an applicant can afford a 95% mortgage. The applicant therefore requires a substantial deposit, for example, a first-time buyer purchasing a property valued at £100,000 would have to provide a deposit in the region of £25,000. Many potential first time home-buyers do not have the funds needed for such a deposit.

As a result of the current economic environment, uncertainty in the housing market and the difficulties in obtaining an affordable mortgage, many potential home-buyers remain in social housing, thereby reducing the availability of social housing for those who may have a greater need. To address this shortage, and to help the housing market and local economy, some local authorities have considered issuing mortgages. However, authorities have limited financial resources and little expertise in this area. There are considerable operational risks attached to residential mortgage activity. The possibility of entering into a partnership with residential mortgage lenders has therefore been explored, with the remit of minimising the financial impact on the local authority, and at the same time taking advantage of the expertise already available from existing mortgage providers.

In September 2009, Sector Treasury Services set up a pilot scheme to assess the viability of a new Local Authority Mortgage Scheme (LAMS), including the legal and accounting issues surrounding a financial indemnity of this nature, and 11 local authorities initially sponsored the pilot scheme. The remit of the pilot scheme included discussions with a range of residential mortgage lenders, with a view to securing options for funding the scheme. Initial discussions with potential funders and partners revealed that due to the high level of set up costs, funders would only be interested in a national scheme, rather than separate arrangements with individual local authorities. Early discussion with the Council of Mortgage Lenders (CML) secured support for such a standard national scheme.

Via the LAMS scheme, the Council has an opportunity to provide targeted help to potential first-time home-buyers in obtaining a mortgage. The scheme is a private sector initiative, not linked to the Right to Buy Mortgage scheme previously provided by local authorities. The scheme is aimed solely at first-time buyers, and the Council will specify the qualifying characteristics for those qualifying for a mortgage under the scheme. The criteria will be driven by the Council's Housing Needs Survey and its, and the national, housing strategy.

#### **2. How the Council's strategic aims and objectives will be met by the LAMS**

The Council's 2021 vision has made it a priority to create an environment to support good housing for all. Good housing improves social, environmental and economic wellbeing and helps to create better communities that can attract investment and skilled workers.

The adoption of the LAMS scheme will contribute to the fulfilment of the council's strategic aims and objectives by enabling first-time buyers to enter the housing market within the district, and subsequently to contribute to its social, environmental and economic well-being. It is a customer and community focused initiative, providing

practical assistance to first-time buyers, whilst freeing up social housing for those in greater need. It demonstrates the Council's aim to create that environment.

### **3. How the LAMS will contribute to housing and other corporate strategies**

The Council's Housing Strategy sets out the Council's approach to housing in the district.

The adoption of the LAMS contributes to the fulfilment of the Council's Housing Strategy by meeting an identified need from first-time buyers for assistance obtaining a mortgage. It will achieve this without involving the Council directly in the residential lending market, of which it has little experience.

### **4. How the LAMS will contribute to the Council's key priorities**

The current economic climate has led to uncertainty in the housing market, and to difficulties in obtaining an affordable mortgage, particularly for first-time buyers. Many potential home-buyers remain in social housing, thereby reducing the availability of social housing for those who have a greater need.

To achieve its 2021 vision, creating an environment to support good housing for all has been agreed as a priority of this Council.

The LAMS addresses this priority enabling first-time buyers wishing to purchase a home in the district without the requirement to save the significant deposit routinely required. In turn, this potentially allows such buyers to move from social housing and accordingly to increase the supply of such accommodation for those with greater need.

The scheme does NOT promote reckless lending, since all applicants must meet the standard lending criteria set out by Lloyds Banking Group, and must be able to provide evidence to demonstrate that the higher loan-to-value mortgage is affordable.

### **5. Criteria for eligibility in the LAMS and the conditions to be applied**

All potential buyers (applicants) will meet the strict credit criteria applied by Lloyds Banking Group. If this initial test is failed, the application for assistance under the LAMS will terminate. If the initial test is passed, the following criteria set by the council will also be strictly applied:

- All applicants will be first-time buyers.
- Only applicants wishing to purchase a property situated in the district of South Kesteven in accordance with qualifying postcodes will be eligible. Applicants may currently reside outside the district boundaries.
- The maximum loan size per application is up to and including £118,750

No other conditions will be imposed or enforced by the Council. In particular, the Council will have no right of first refusal on the sale of a property subject to an indemnity under the scheme, and there will be no second charge made on the borrower's home.

### **6. Type of assistance available under the LAMS**

Lloyds Banking Group (LBG) provides funds under a "cash-backed" arrangement. The Council is required to make a 5-year deposit with LBG at the inception of the scheme,

equivalent to the full value of the total indemnities being offered. Interest will be paid annually by LBG at a premium fixed rate.

If a potential buyer meets all the criteria at paragraph 5 (above), the Council will provide a “top-up” indemnity to the value of the difference between a 75% loan-to-value, and a 95% loan-to-value mortgage. The prospective home-buyer will thereby obtain a 95% mortgage on similar terms to a 75% mortgage, but without the need to provide the usual deposit.

Individual indemnities will be in place for a fixed 5 year period for each mortgage granted by LBG under the scheme. This period may be extended by a further 2 years only if a mortgage granted under the scheme is in arrears during the last 6 months of the initial 5 year period.

Assuming no default by the home-buyer, the Council’s indemnity liability will terminate on the earliest of the end of the agreed indemnity period, i.e. the end of the 5-year period, or on the date of the early repayment of the mortgage.

## **7. Capital resources available under the LAMS Cash-backed scheme**

Once legal documentation has been completed to establish a local scheme the Council will deposit funds with Lloyds Banking Group to the limit of the maximum indemnities to be offered. The bank will pay an enhanced rate of interest on this advance.

The sum to be made available by the Council under the LAMS will be £1million for which budget provision has been made.

The emphasis of a cash-backed arrangement, and the overall substance of the transaction, is that the Council is providing financial assistance to facilitate a lender making available a greater amount to the borrower than would otherwise be their practice. Expenditure of a local authority can qualify as capital expenditure as set out in regulation 25 of The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. Section (1)(c) of the regulation defines that “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”, shall be treated as being capital expenditure.

## **8. Amount of assistance available to individual applicants under the LAMS**

Lenders, such as Lloyds Banking Group, require the maximum individual loan size to be stipulated at the inception of the scheme (i.e. 95% of the average property valuation locally), rather than the maximum “property valuation”.

The following criteria will be applied in respect of the South Kesteven District Council scheme:

- The maximum loan size per application towards which assistance may be given to a first-time home-buyer is up to and including £118,750
- The maximum individual indemnity to be offered to a first-time home-buyer under the scheme is 20%.
- Only applicants wishing to purchase a property where the post code is wholly within the boundaries of the district of South Kesteven will be eligible. Applicants may currently reside outside the district boundaries.

## 9. Application Process for the LAMS and the fees payable

At the inception of the scheme, a promotional article will be published on the council's website, together with a link to the full LAMS policy document.

Whilst the council will be an "enabler" in that its cash deposit with LBG makes the scheme possible, the scheme will be administered solely by LBG, to whom all enquiries applications, comments and complaints should be directed.

Under no circumstances will any council officer offer specific advice to a prospective home-buyer on the suitability of the LAMS for their individual needs. This is the role of LBG as the mortgage lender. Accordingly, no specific training is required by the council's own staff in respect of the scheme.

The steps to be followed by a prospective first-time home-buyer interested in the scheme are as follows:

- The home-buyer will visit a branch of LBG to make an appointment to discuss their requirements.
- LBG will assess the home-buyer as a prospective borrower, in accordance with its usual strict affordability criteria.
- LBG will then assess whether the LAMS scheme is suitable for the prospective borrower, i.e. whether the council's own criteria set out at paragraph 5 are met.

No fees in excess of those normally levied by LBG in the course of their mortgage business will be payable by the prospective home-buyer.

## 10. Commercial issues in respect of the LAMS

In accordance with legislation, LBG will not have a legal charge over the Council's deposit under the LAMS, therefore should an indemnity be called, a separate invoice will be issued by LBG.

An individual indemnity will only be called upon if a loss is actually incurred by LBG. For example, if a property valued at £125,000, with a LAMS mortgage of £118,750 and a Council indemnity of £25,000, is sold upon repossession for £95,000, net of all attributable costs, (ie. a total loss of £35,000) the full value of the £25,000 Council indemnity will be payable by the Council to LBG. The loss in excess of the value of the Council indemnity will be met by LBG, ie. £10,000 in this example. However, if the same property is sold for £115,000 net of all attributable costs, (i.e. a total loss of £10,000), the sum of £10,000 will be payable by the Council to LBG. In each scenario, the Council will make payment to LBG within 30 days of being invoiced for the charge.

Given that an indemnity will only be called when all normal mortgage business processes have been explored by LBG, i.e. if a borrower finally defaults on a mortgage and the property is repossessed, it is extremely unlikely that the Council will be able to recover any part of the value of the indemnity from the individual. Should an indemnity be called, appropriate provision will need to be made in the revenue accounts.

Whilst the deposit required by a cash-backed scheme would count as capital expenditure rather than a simple investment within the meaning of the investment strategy, it will expose the council to the creditworthiness of Lloyds Banking Group. At

present the credit rating of LBG is within the range allowed by the council's Treasury Management Strategy Statement.

## **11. Legal issues**

LBG require the following legal documents to set up the scheme:

- Indemnity deed for the LAMS
- Legal indemnity - an opinion letter, confirming that the Council has the power to enter into, observe and perform the terms and obligations required of it under the LAMS.

## **12. Risks**

There are a number of risks associated with the LAMS. A risk assessment, outlining all the key risks identified, together with the mitigating controls, is attached at appendix 1 to this Policy.

## **13. Other issues**

Due to the changing environment in which the Council operates, further legal and accounting advice may be required during the life of the LAMS. To ensure consistency, Sector will obtain updated advice on behalf of participating authorities. Any additional fees incurred in this respect will be agreed with all parties in advance.

The accounting paper prepared by Sector is attached at appendix 2 to this policy. It indicates that the Council may set aside the eventual capital receipt (the repayment of the deposit) to finance the initial capital expenditure (the deposit). Provided that this intention is explicitly stated in the MRP Policy, together with a statement that no minimum revenue provision will be made in respect of LAMS expenditure, the arrangement will meet required accounting standards.

## LAMS Policy Appendix 1

	Strategic Risk	Key Risk	Risk Rating	Likelihood	Impact	Preventative Measures	Notes
F1	Financial	Local authority affordability	Moderate	Low	Moderate /High	Make adequate budget provision	For cash backed guarantees it may be prudent that the interest earned on the deposit is set aside in a ring fenced reserve to be used to fund future liabilities in the event of failure or default, and the guarantee being called upon.
F2		Lending to sub-prime applicants	Low	Low	Moderate	Use lender's existing credit criteria	
F3		Applicant affordability	Low	Low	Moderate	Lender will ensure the mortgage is affordable	
F4		Costs incurred in the event of a guarantee being called	Low	Low	Low	The number of repossessions by first charge mortgage lenders in 2010 was 0.3% of all mortgages (source: CML website). For each £1m, there is a potential for loss of £3,000 if each default leads to a 100% loss of the value of the guarantee. For 95% LTV mortgages this may be higher, perhaps 1-2%. The cash-backed guarantee will attract a premium investment return in the region of 4.1%, i.e. each £1m allocated to the scheme will earn £41,000.	No specific statistics available for first time buyers only. Figures could be refined further to cover local or regional areas. For this purpose, it is assumed that the full value of the guarantee will be lost in the event of default.
F5		Counterparty risk	Low	Low	High	Partnership with highly reputable financial institutions for deposits. Ensure compliance with the TMSS.	The cash-backed mortgage support should not be seen as a straightforward deposit with a financial institution. Participating local authorities may be required to provide a "financial advance" to the participating mortgage lender (to support mortgages in the local economy), so the requirements of the scheme would be slightly different to the usual investment principles. This should be identified in the TMSS.
R1	Reputation	Poor publicity or bad press about the use of public money	Moderate	Low	Low	Press officer to liaise closely with the local press. Promotion of benefits of the scheme, i.e. supporting the local housing market and local economy. Good promotional material. Joint working with partners and estate agents. Press releases and photo opportunities.	Sector and the participating lenders will support the promotional process.

	Strategic Risk	Key Risk	Risk Rating	Likelihood	Impact	Preventative Measures	Notes
R2		Repossession in the hands of the lender, therefore outside the local authority's area of responsibility	Moderate	Moderate	Low	Lender to inform local authority if and when an applicant is facing repossession. LA may be able to support people to prevent repossession.	
R3		Poor publicity or bad press about possible repossession	Moderate	Moderate	High	Is the local authority support an issue? Early notice from lender to the local authority if action is due to be taken. Local authority to assess the alternative options	
P1	Political	Lack of political support	Low	Low	High	Ensure political support from the outset. Continued member briefing of progress on the scheme, and on the value of the guarantees offered.	Sector will support this process.
P2		Change of political priorities	Low	Moderate	Low	Future support for the scheme may be withdrawn, but existing support would remain until expiry.	
O1	Operational	Adverse impact on existing staffing levels	Low	Low	Low	The local authority will have no input in the assessment or processing of mortgage applications.	
O2		Housing market fully recovers and the scheme no longer required	Moderate	Moderate	Low	The scheme will cease to exist. Guarantees already granted (5 years + a further 2 years if the account is 90+ days in arrears) would remain in place.	Further analysis of local and regional housing issues to be added, i.e. local housing need, house prices, mortgage approvals etc. This information will determine the anticipated life of the scheme.

### **Sector's Accounting Paper on the accounting requirements for a funded indemnity as offered by Lloyds Banking Group**

This paper provides an outline of the accounting implications for local authorities who are considering providing assistance to participating lenders wishing to provide mortgage advances under the Local Authority Mortgage Scheme (LAMS). This paper outlines the accounting requirements for the scheme offered by Lloyds Banking Group (LBG).

#### **Lender Agreement:**

A formal agreement is now in place with Lloyds Banking Group (LBG). As part of this agreement authorities will be required to deposit funds with the bank, equivalent to the limit of the guarantee / support. In the case of default by the mortgagor, there will be an obligation for the authority to reimburse the bank as soon as a loss is realised. The bank will pay an enhanced rate of interest on the original advance from the authority.

#### **Proposed Accounting Treatment:**

The emphasis of the LBG arrangement and the overall aim or substance of the transaction is that the authority is providing financial assistance (rather than a financial guarantee) to facilitate the bank lending a greater amount to the borrower / mortgagor than would otherwise be their practice.

In England one of the routes by which the expenditure of a local authority can qualify as capital is set out in regulation 25 of The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. Section (1)(c) of the regulation defines that "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 " shall be treated as being capital expenditure.

If and when a loss is realised by the lender and the local authority is required to compensate the bank, the authority will have the choice of making a separate payment or having the amount deducted from the original advance. A deduction from the original advance might result in breakage costs being incurred; it is therefore likely that authorities will prefer to make a separate payment at the time. It is important to note that the authority will have already recognised the full amount of any potential liability in its balance sheet, in the form of a long-term debtor. The obligation for the authority to pay on default should therefore be viewed as the amount of bad debt that would need to be charged, as in any other type of loan situation.

In line with previous CIPFA guidance, although write-offs of the principal part of advances and provisions for doubtful debts are legitimate charges against the authority's net expenditure, they do not need to be financed from council tax (unlike corresponding transactions in relation to interest).

The original advance constitutes expenditure for **capital** purposes. Any debits made to service revenue accounts in relation to principal must therefore be cancelled out in the Movement in Reserves Statement by an appropriation credit from the Capital Adjustment Account.

## CFR and MRP Liability:

If the original advance (capital expenditure) was not financed, there would be an increase in the authority's CFR, which in turn would create an additional MRP liability.

The authority can however opt to meet this liability by setting aside the associated repayment from the bank, which in accordance with accepted accounting practice would be regarded as a capital receipt.

In the event of a default, an authority that has previously agreed to adopt the latter practice of setting aside the capital receipt would need to consider alternative arrangements for repayment of the remaining debt liability, as the final net receipt would be insufficient to cover the full liability associated with the original transaction. The authority would therefore need to either introduce an MRP charge or apply other resources (such as a revenue contribution), equivalent to the amount of the total default, in order to extinguish the remaining CFR liability. The preferred MRP treatment should be addressed in the authority's annual MRP Policy.

Example accounting entries are outlined below, assuming a set aside of the capital receipt and an interest rate of 4.1%:

	CIES	MiRS	LT Debtor	Debtor	Cash	Cap Adj Account	Capital Receipts
Y1 Adv to Lloyds Banking Group			1,000,000		-1,000,000		
Y1 Interest Receivable	-41,000				41,000		
Y2 Interest Receivable	-41,000				41,000		
Y3 Interest Receivable	-41,000				41,000		
Y4 Interest Receivable	-41,000				41,000		
Y4 Bad Debt written off	10,000		-10,000				
Y4 Appropriation to CAA		-10,000				10,000	
Payment to bank for default				10,000	-10,000		
Y5 Interest Receivable	-41,000				41,000		
Y5 Repayment of original deposit				-10,000	1,000,000		990,000
Y5 Write off to CAA			-990,000			990,000	
<b>CLOSING BALANCE</b>	<b>-195,000</b>	<b>-10,000</b>	<b>0</b>	<b>0</b>	<b>195,000</b>	<b>1,000,000</b>	<b>-990,000</b>

The above example assumes a default of £10,000 in year 4, based on the current national average default rate of 1% as published by the Council of Mortgage Lenders. Although write-offs and provisions for doubtful debts are legitimate charges against the authority's net expenditure, they do not need to be financed from council tax (unlike corresponding transactions in relation to interest). The original advance constituted expenditure for capital purposes and its financing would be concluded in the year the expenditure was incurred. Any debits made to service revenue accounts in relation to the principal should therefore be cancelled out in the Movement in Reserves Statement by an appropriation credit from the Capital Adjustment Account. From items originally debited or credited to the service revenue accounts, this will leave a net charge against

the amount to be raised from council tax comprising management costs and interest receivable. The payment to the bank for default is classed as an additional cash-flow debtor.