Essential Reference Paper B

(note: Appendices not included here)

Local Authority Mortgage Scheme

1. Background

The turmoil in the financial and banking market has had a severe impact on both the local economy and on local housing. House prices have continued to fall, and the outlook remains uncertain. The lack of buyers, together with the ongoing lack of mortgage availability means house prices are likely to continue to slide. Nationwide Building Society predicts house prices throughout 2011 to stay weak as a result of the uncertainty surrounding the economy and the Government's massive spending cuts.

There is still considerable concern about some areas of the housing market, particularly the low percentage of first time buyers. According to the Council of Mortgage Lenders (CML), mortgage lending in July 2011 fell by 6% compared to July 2010. The CML believes the housing market will remain subdued in 2011 due to uncertainty surrounding the economy and the ongoing mortgage rationing by lenders. The level of activity in the mortgage market is expected to drift lower over the coming months.

Current constraints are a particular problem for first-time buyers, especially those unable to provide a substantial deposit. While mortgage insurance, shared ownership, and product innovation can all potentially play a part, none will provide a "magic bullet" to normalise the mortgage market for first-time buyers. This is likely to be a gradual process as confidence in funding markets and lending decisions is restored in the light of a more stable market environment. The preference for low loan to value mortgages is therefore expected to continue to restrict first time buyers in the current financial environment.

As a result of the recession and the adverse affect on the local economy and the housing market, a number of Local Authorities are trying to take a proactive approach in supporting the local area, and also to address pressing issues in increasing the supply of affordable housing.

2 Current situation

Most mortgage lenders are typically prepared to lend a maximum of 75% - 80% loan to value (LTV), even if the applicant can afford a 95% mortgage. This means the applicant requires a substantial deposit, e.g. 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 the 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 may remain in social / affordable housing units, thereby reducing the availability of social / affordable housing for those who may have a greater need. Increasing the supply of affordable / social housing is a key corporate priority for most Local Authorities.

To address the shortage in supply of affordable housing to those who need it, and to help the housing market and the local economy in general, a number of Local Authorities have considered issuing mortgages to potential home-buyers. However, Local Authorities have limited financial resources available for this purpose, and they also have limited staffing resources and expertise in this area to manage their own mortgages. There are also considerable operational risks attached in entering into this area of residential mortgage activity.

Rather than entering into the residential mortgage market themselves, Local Authorities have therefore explored the possibility of entering into a partnership with residential mortgage lenders, 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. 11 Local Authorities initially sponsored the pilot scheme.

The remit of the pilot scheme included initial discussions with a range of residential mortgage lenders, with a view to securing options for funding the scheme. Initial discussions with potential funders / partners revealed that due to the high level of set up costs, funders would only be interested in a large national scheme rather than separate arrangements with individual Local Authorities. It was also considered appropriate to discuss the proposed scheme with the Council of Mortgage Lenders (CML). Early discussion with the CML has secured support for a standard national scheme.

Following the successful completion of the pilot scheme, this report outlines the scheme where the Local Authority can provide targeted help to potential home-buyers to enable them to obtain a mortgage. The scheme is a private sector initiative, i.e. not linked to the Right to Buy Mortgage scheme previously provided by Local Authorities.

3. The Local Authority Mortgage Scheme

The scheme is aimed at first time buyers, providing help for potential buyers who can afford mortgage payments - but not the initial deposit – to get on to the property ladder. Under the scheme, each Local Authority will be able to specify three qualifying criteria; the maximum level of indemnity, the maximum loan size (based on 95% of maximum property valuation) and the qualifying post codes. The scheme is standardised as much as possible

If a potential buyer meets the strict credit criteria applied by the lender, and meets the criteria set out by the Local Authority to qualify for a mortgage under the scheme, the Local Authority will provide a top-up indemnity to the value of the difference between the typical LTV (i.e. 75%) and a 95% LTV mortgage. The potential buyer will thereby obtain a 95% mortgage on similar terms as a 75% mortgage, but without the need to provide the substantial deposit usually required.

It should be stressed that the scheme does not promote reckless lending, it is essential that the applicants meet the standard lending criteria as set out by the lender, and that the higher LTV mortgage is affordable.

The indemnity will be in place for a fixed 5 year period for each mortgage granted under the scheme, which may be extended for a further 2 years if a mortgage were in arrears in the last 6 months of the initial 5 year period.

The indemnity would only be called upon if a loss is crystallised by the lender. By way of example, a property valued at £100,000, with a mortgage of £95,000 and with Local Authority indemnity of £20,000 is sold at £70,000, net of attributable costs. The full value of the £20,000 indemnity would be requested by the lender. If the property is sold at £90,000 net of costs, i.e. an actual loss of £5,000 is incurred by the lender, £5,000 would be requested from the Local Authority. Any loss in excess of the value of the indemnity would be attributable to the lender. The lender would request payment from the Local Authority, who would undertake to make payment within 30 days.

The table below shows potential number of first time buyers the scheme may initially assist based on £1m advance, assuming a purchase price of £100,000.

Total Local Authority Indemnity	£1,000,000
Assumed Max Loan Size	£100,000
5% Deposit	£5,000
95% Mortgage	£95,000
Local Authority Indemnity	£20,000
Potential number of mortgages	50

It is anticipated that the Local Authority will set a maximum annual limit for indemnities offered, either in total or for the forthcoming year. The indemnity could be either unfunded or “cash-backed”, depending on the requirements of the lender.

If the indemnity is un-funded, the Local Authority will receive a premium a fixed amount of the value of the indemnity actually provided, typically in the region of £500 per mortgage. The accounting requirements for an un-funded indemnity with a premium attached are covered in Appendix A (Accounting Paper 2).

If the indemnity is “cash backed”, i.e. supported by a deposit, the Local Authority will be required to place a 5-year deposit at the start of the financial year to the full value of the indemnity being offered. The deposit will be in place for the term of the indemnity – i.e. 5 years (with the possibility of a further 2 year extension if the mortgage is in arrears at the end of the initial 5 years) - and may have conditions / structures attached. The Local Authority will receive a 5-year commercial deposit rate + a premium of 0.70% from the first lender to join the scheme, other lenders will offer similar terms.

In accordance with the legislation, the lender will not have a legal charge over the deposit. In the event of an indemnity being called and an amount being payable by the Local Authority to the lender, a request for payment would be made by the lender. The Local Authority will undertake to settle the amount payable within 30 days. The accounting requirements for the “cash backed” indemnity are shown in Appendix A1 (Accounting Paper 3)

For both types of indemnity, and assuming no default by the buyer, the indemnity liability would terminate on the earliest of the end of the agreed indemnity period (i.e. 5 years) or an early repayment of the mortgage. In the case of a cash-backed indemnity, the fixed-term deposit would be repaid to the Local Authority at the date of maturity, plus interest due.

Appendix B sets out the legislative framework that would give a Local Authority in England, Wales and Scotland the power to implement the Scheme. Appendix B also provides an outline of policy and commercial issues that a Local Authority should consider when deciding how to implement the Scheme. We have also taken advice on the State Aid, and a summary of the position is attached in Appendix C.

There are a number of risks associated with the scheme, and the Local Authority should give careful consideration to how to manage these risks and the mitigating controls to be put in place. A Risk Assessment, outlining the key risks and potential mitigating controls are attached in Appendix D.

When a Local Authority decides to participate in the LAMS, they should initially agree the criteria required to qualify for the scheme. The local criteria are:

- The maximum limit for the total indemnity to be offered under the scheme.
- The maximum loan size (based on maximum property valuation)
- The qualifying post codes within the boundary area

Once these parameters have been set, the mortgage lender should manage the operational side of the scheme without any direct input from the Local Authority. Sector Treasury Services will undertake an annual audit of the scheme to ensure both parties are fully compliant with the agreement.

Due to the changing environment, further legal and / or accounting advice may be required during the life of the LAMS. To ensure consistency, it is anticipated that Sector Treasury Services Ltd will obtain updated advice on behalf of participating authorities. Any additional fees incurred in this respect will be agreed with all parties in advance.

4. Conclusions

The Local Authority Mortgage Scheme is designed to help increase the supply of affordable housing for those who need it, and to help the local housing market and thereby the local economy.

The scheme has been designed to minimise the financial impact on the Local Authority, and to work in partnership with a range of experts in the market, i.e. residential mortgage lenders.

The scheme requires the Local Authority to provide a financial indemnity of up to 20% of a mortgage for potential home-buyers who qualify for Local Authority support, and who meet the strict lending criteria set by the lender.

The scheme does NOT promote reckless lending or provide un-affordable mortgages, it simply reduces the value of deposit currently required.

The indemnity could be un-funded or ‘cash backed’.

The pilot scheme has obtained Counsel’s opinion on the legality of the scheme, as attached in Appendix B. The advice has been obtained on behalf of all participating Local Authorities, however, each authority should ensure the Council’s Monitoring Officer is satisfied with the advice provided.

The pilot scheme has provided comprehensive accounting advice on both the un-funded and the cash-backed option, as attached in Appendix A.

The pilot scheme has produced a Risk Assessment, as attached in Appendix D.

The scheme is currently supported by five mortgage lenders; one national lender (Lloyds Banking Group), and four smaller lenders; Furness BS, Saffron BS, Leek United BS and Teachers BS. It is expected that further lenders will be joining the partnership at a later stage. It is a requirement of the scheme that mortgage applicants should have a choice of mortgage providers, and the scheme should be available to all lenders on a national basis.

The scheme was launched nationally in March 2011, and mortgages are currently available in Blackpool and Warrington. A further six Local Authorities are due to launce the scheme during September / October

5. Recommendation

That the Local Authority adopts the LAMS in accordance with the outline provided within this report.