Report to: **Cabinet**

Subject: **Local Authority Mortgage Scheme (LAMS)**

Date: **1 September 2011**

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PURPOSE OF REPORT

The report seeks members' approval for the establishment of a Local Authority Mortgage Scheme, which is designed to aid local first time buyers with the purchase of their home.

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 spending cuts.

There is still considerable concern about some areas of the housing market, particularly the low percentage of first time buyers. The Council of Mortgage Lenders (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 therefore expected to remain subdued.

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.

THE 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, and 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.

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 the qualifying characteristics for those who should qualify for a mortgage under the LAM scheme. The criteria should be driven by the Council's housing needs survey and the housing strategy. However the scheme itself 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 <u>without</u> the need to provide the substantial deposit usually required.

It should be stressed that the scheme does <u>not</u> 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 was in arrears in the last 6 months of the initial 5 year period.

The indemnity would <u>only</u> be called upon if a loss is incurred by the lender. For example, if a property valued at £100,000, with a mortgage of £95,000 and a Local Authority indemnity of £20,000 was sold for £70,000, net of attributable costs (ie. a loss of £25,000 to the lender) the full value of the £20,000 indemnity would be requested from the Local Authority by the lender. The loss in <u>excess</u> of the value of the indemnity would be attributable to the lender, ie £5,000 in this example). However, if the property was sold for £90,000 net of attributable costs, (ie. an actual loss of £5,000 is incurred by the lender), £5,000 would be requested from the Local Authority, which would undertake to make payment to the lender within 30 days.

The table below shows potential number of first time buyers the scheme may initially assist based on £1m advance, and assuming a purchase price of £100,000, £125,000 and £150,000.

Total Local Authority Indemnity	£1,000,000	£1,000,000	£1,000,000
Assumed Maximum Property Price	£100,000	£125,000	£150,000
5% Deposit from buyer	£5,000	£6,250	£7,500
95% Mortgage from Lender	£95,000	£118,750	£142,500
Local Authority Indemnity (95%-75%)	£20,000	£25,000	£30,000
Potential number of mortgages available	50	40	33

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 of a percentage of the value of the indemnity actually provided, or a specified fee per mortgage.

If the indemnity is "cash-backed", ie. 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, ie. 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 or structures attached. It should be noted that the first lender to participate as a partner in this scheme, Lloyds TSB, requires a cash backed indemnity.

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 will be made by the lender. The Local Authority will undertake to settle the amount payable within 30 days.

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, ie. at the end of the 5 year period, or on the date of the 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 the interest due.

The pilot scheme has obtained advice on the legality of the scheme. The legal white paper was written by external lawyers, and these documents were funded by the pilot authorities. Sector has an agreement with the pilot authorities that any further councils signing up to the LAMS scheme will make a contribution to these costs in the sum of £3,000. Whilst the advice has been obtained on behalf of all participating Local Authorities, should members agree to implement the scheme, Gedling's own Monitoring Officer will be required to confirm that she is satisfied with the advice provided.

Sector has also taken advice on the State Aid position, and as above, the Monitoring Officer should confirm that she is satisfied with the advice provided.

The main mortgage lender requires the Council's Monitoring Officer to provide 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 Scheme and a Monitoring Officer's Indemnity Deed. This is a personal matter for the Monitoring Officer, and will require a Council indemnity for the Monitoring Officer for providing the opinion. This means that in the highly unlikely event of the Monitoring Officer acting negligently, the liability will lie with the Council, not with the Monitoring Officer. The Council will therefore also be required to indemnify the Monitoring Officer in respect of any personal liability he or she may incur by providing the Opinion Letter.

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 is attached at Appendix 1.

It is anticipated that if the council decides to participate in the LAMS, it should initially agree the criteria required to qualify for the scheme, ie. first-time buyer only etc. It should also set a maximum limit for the total indemnity to be offered under the scheme, ie £1m in total etc. 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 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 will obtain updated advice on behalf of participating authorities. Any additional fees incurred in this respect will be agreed with all parties in advance.

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, ie. residential mortgage lenders. The scheme can be implemented within existing treasury resources, and it is not considered that the risks are sufficiently material to require any additional revenue bad debt provision at this stage.

- 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 from the home-buyer.

- The indemnity can be “un-funded” or “cash-backed” (although the lender currently available offers only the cash-backed option.)

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

- The pilot scheme has produced a risk assessment, as attached at appendix 1.

- The scheme is currently supported by one major mortgage lender, Lloyds TSB, with further potential funders joining the partnership at a later stage. Lloyds offer the cash-backed option. 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.

- LAMS is now fully operational, with Local Authority mortgages available in the retail market.

The Housing Strategy Manager has advised that there is likely to be considerable interest in a scheme of this nature. There are currently 42 people on the council’s list for affordable housing, and on average two calls per week are received seeking details of what is available in the Gedling area. Many of these are unable to raise the size of deposit routinely being required by mortgage lenders, which averaged 23% in February 2011.

RECOMMENDATIONS

It is recommended that:

1. Cabinet agrees in principle to adopt the Local Authority Mortgage Scheme in accordance with the outline provided within this report.

2. The Portfolio-holders for Finance and Performance and Health and Well-being, in consultation with the Head of Corporate Services and the Council Solicitor and Monitoring Officer, be authorised to finalise the details of the scheme, and subsequently to report back to Cabinet on a final scheme for adoption by Full Council.

3. If the Scheme proceeds, the Council agrees to indemnify the Monitoring Officer in relation to any opinion or indemnity he/she is required to give as outlined in the report.

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%, ie. 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.

	Strategic Risk	Key Risk	Risk Rating	Likelihood	Impact	Preventative Measures	Notes
R1	Reputation	Poor publicity or bad press about the use of public money	Moderate	Low	Low	Press officer to liase closely with the local press. Promotion of benefits of the scheme, ie. supporting the local housing market and local economy. Good promotional material. Joint working with partners and estate agents. Press releases & photo opportunities.	Sector and the participating lenders will support the promotional process.
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, ie. local housing need, house prices, mortgage approvals etc. This information will determine the anticipated life of the scheme.