Appendix H – Croydon Affordable Homes/Tenures Briefing Note

1. In Financial Year 2017/18 the Council set up an LLP structure, including a charity, in order to increase supply of affordable housing, utilise 1-4-1 RTB receipts and receive income to support the Council's MTFS position.

2. As part of the 2019/20 Audit the Council's auditors have raised significant concerns in relation to the accounting treatment and substance of the structure; this is further explained within section 3.

3. The LLP structure consists of 5 LLP companies, with the Council having a 99% membership of LBC Holdings LLP which, itself, holds a 10% membership of the other sub-LLPs in the structure. An independent charity, Croydon Affordable Housing (the "Charity"), holds a 90% membership in each of the LLPs (other than LBC Holdings LLP). Out of a total of 4 sub-LLPs that were set up, as indicated within Appendix 1, only two are operational and the rest are dormant. The two that are operational are Croydon Affordable Home LLP (CAH) and Croydon Affordable Tenures LLP (CAT). Both together will be referred to as LLPs.

4. As part of a series of transactions, largely back to back for each LLP, the Council disposed of a total of 344 properties on an 80 year lease arrangement. 96 properties were transferred to CAH in November 2017 and 248 properties were transferred to CAT under two tranches with Tranche 1 being 167 properties in March 2019 and Tranche 2 having 81 properties in December 2019.

5. To enter into the lease agreement with the Council for the 344 properties, the Council provided CAH and CAT funding by way of loans and 1-4-1 right to buy capital receipts (under a facility agreement), which the LLPs used to fully pay their liability to the Council under the head lease. The value of the combined funding to the LLPs (CAH & CAT) was circa £112m, consisting of loans from the Council (circa £79m) and granting of RTB 141 receipts (circa £33m).

6. CAH and CAT were then provided with funding by external funders (Canada Life and Legal and General Assurance Society Limited, respectively), through an upfront lease premium under an underlease covering an 80-year term (with a 40-year break clause that can be exercised by CAH and CAT under the agreement; option deed for the transfer of the underlease). CAH and CAT used this upfront lease premium to part repay the Council's loans. CAH and CAH pay the external funders an investment return as per the amount disclosed in the underlease. The investment return is fixed but rises by CPI annually.

7. Within this arrangement a number of other agreements were also established, such as the Council providing a covenant in respect of the payment of the investment return to the funders and the Council has entered into an 80-year property management agreement with CAH and CAT for the Council to provide management and maintenance services to the LLPs.

8. The Council accounted for the disposal of the leases to the LLPs as a finance lease and therefore treated the premiums of c£112m from the LLP for the lease as capital receipts. The Council does not hold the 344 properties on its balance sheet as they were deemed as disposed. The Council then used the receipts from the LLPs to fund £73m of transformation projects (under the Flexile Use of Capital Receipts arrangements for Local Authorities and to finance the capital programme with the balance of c£38m.

9. A further set of transactions includes the repayment of the initial loans by the LLPs using the monies they received from the external investors and the loan balance was reduced to £8.1m. The LLP will pay the remaining loan over a 40 year period and so far all annual commitments have been paid by the LLPs.

10. The Council's external auditors, Grant Thornton (GT), have raised concerns in regards to the structure and how the transactions between the stakeholders have been accounted for in the Council's year end accounts. These challenges include:

    a. On the basis of the transactions as detailed within Section 1 GT challenged whether the risk and reward associated with the properties were ever transferred at the outset of the agreement, and if there was a lease in place then it would be an Operating Lease as opposed to a Finance Lease

    b. Upon considering the whole suite of transactions rather than on perhaps the individual basis it appeared to GT that the Council was the party that the investors transacted with and the LLP is almost just a pass through.

11. The Council commissioned PwC to carry out an independent review of the LLP Structure and were asked to help with examining and advising on the Council's options in responding to Grant Thornton on this issue, particularly the claim 10a (above). Along with PwC support the Council also commissioned legal advice from James Goudie QC to ensure the structure also passed the legal test.

12. GT's challenge raised two potential implications for the Council. Firstly, if it were deemed that the LLP was just a pass through then the application of the 1-4-1 Capital Receipts would have been unlawful as the control test would have failed. Secondly, if the head lease transfer should be classified as an operating lease then the Council would need to unwind the £112m of capital receipts.

13. The Council is comfortable that the legal advice, along with its own management view, indicates that the setup of the structure is not just a pass through. Therefore, GT's second challenge as indicated within 10.b can be responded with a strong degree of confidence. The LLPs do have substance and that the LLP's control test is met as advised by the draft legal opinion from James Goudie. However James Goudie is unequivocal in his view that the structure is of

substance and that the LLPs have independence. This therefore reduces the risk of the entire structure needing to be re-considered for accounting purposes. Particularly, it ensures that the granting of the 1-4-1 Capital Receipts has been correctly done.

14. The Council has also received a draft report from PwC, which provides a rather open ended view of the lease arrangements and does not come to a conclusive position. The complex nature of the agreements indicates that further work will be required with GT to understand their view. GT have asked for the Council to provide a further paper to determine all risks and rewards, within its management assessment, have been transferred to the LLP.

15 The Council has 3 options that could resolve this matter. Option A has been to find all avenues, including engaging with CIPFA policy team to get a view on the lease indicators and CIPFA were asked to attend a meeting (also including DLUHC, PwC, Improvement Panel members and our external auditors along with senior Council officers) to provide their view on how to interpret the Code of Practice to determine the lease classification. The Code and the IFRS standards state that to classify a lease as a finance lease the criteria either 'individually or collectively' needs to be met. There are broadly two views to this, one being that only one criteria potentially needs to be met, out of the eight, for it to be classified as a finance lease and the second that it refers to a weighted assessment. The latter indicating that a number of indicators need to be met rather than just a single one. Albeit the auditor's view is that the assessment needs to be looked at in the round.

16 Option B has been to ensure comprehensive information has been provided to PwC for each of the 8 criteria to provide a correct assessment. One of the indicators which needed further work was to test the actual life of the properties that were transferred to the LLPS. The Council's Property and Assets team has assessed the economic life and based on the condition of the properties his view is that that asset life of the properties that were transferred to the LLPs have a life span between 25 and 75 years, which is within the 40 year lease period. If the asset life of properties is close to the lease term it strongly indicates a finance lease. The outcome of this review suggests that there is an argument to split the land and building components of the properties and it further reveals that the land is more likely to be an operating lease and the buildings are finance leases. The challenge back from GT has been to further test if the risk and reward has been transferred even when componentising and this needs further work to better understand on the likelihood of this option being successful.

17 The Council has also been planning in the event the lease was classified as an operating lease. We believe that it best to plan for such a scenario and this is Option C. The Council is working to re-consider the flow of transactions that would take place if the

lease arrangement are classified as an operating lease. The Council received capital receipts through two transactions and the Council may have the option to convert the second flow of capital receipts to cover the costs of transformation funding. This option has been put forward to GT however due to the complexity of the transactions and the structure it is felt further discussions will need to be held to ensure GT understand the dynamics of this Option C.

18 The worst case scenario for the Council is that the arrangement does not meet the Finance lease test, in which the Council will need to correct its historic accounts and it will result in a minimum of a £112m reversal of entries as indicated within 5. Whilst the Council could replace c£39m of the £112m using borrowing, as it was used to finance the capital programme, the balance of £73m which was used to fund re`1venue spend, under flexible use of capital receipts regime, would be a direct charge to the Council's Revenue account. The council does not have sufficient balances to cover the charge and therefore it would need to seek additional support, most likely a capitalisation direction. A capitalisation would be a route as of last resort and would only occur if the Council is unable to gain an agreement from the auditors.

19 It is expected that this work will roll over into the new Financial Year and it will further delay the finalisation of the 2019/20 audit work.