

The reform of council housing finance

SEPTEMBER 2009

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HQN welcomes the government's proposals to reform HRA finance, but cautions that the detail will be critical to whether the full potential benefits are achieved. If HRA Subsidy is abolished as proposed, this would remove a hugely complex system which has produced some perverse incentives, and create a position close to a level playing field between councils, housing associations and the private sector in the provision of affordable housing.

With consultation responses due by 27 October, we present a commentary, including a checklist of issues which ALMOs and councils may wish to consider in framing their responses, both to the 17 specific questions posed, and to the consultation paper in general. For ease of reference it starts at section 3 and follows the structure of the consultation paper. We will be running events to examine the proposals in more detail in London on 8 October and Manchester on 13 October – see http://www.hqnetwork.co.uk/forthcoming_events for more details and to book your place.

Management and maintenance

The paper states that research commissioned by Communities and Local Government (CLG) suggests that the need for expenditure on management and maintenance is 5% higher than the current subsidy allowances nationally. Because it also says that '...further work is needed to understand how this is distributed at the local level', no council can know what the potential allowance assigned to them will be. There is also no timescale for the introduction of revised allowances, assuming that the current system will continue for some time. This gives rise to the first items in our checklist:

- You may wish to welcome the 5% increase in assumed management and maintenance at the national level, or perhaps comment that it is inadequate
- Although this paper does not comment on how the assumed management and maintenance costs will be distributed, you may nonetheless wish to comment on this
- You may wish to request that revised allowances be introduced from 2010/11, pending any future amendment to the subsidy system.

Major repairs

On the Major Repairs Allowance (MRA), the paper suggests that a number of items which were not included in the original MRA calculations should now be included. Together with changes to expected component life expectancies, this would produce an average 24% increase in MRA (but again, there are no details of the impact on individual councils). Earlier in the review process, it was reported in the press that a need for a 40% had been identified. We believe some of the difference may be due to the decision that disabled adaptations should not be included.

The paper also acknowledges that backlogs of repairs will continue beyond 2010 and suggests that capital grant will be available for these. Capital grant is less flexible than Supported Capital Expenditure (for example, it will be required to be utilised in the year it is received), but is consistent with the proposal to end the HRA Subsidy system.

- You may wish to welcome the proposed addition of items previously excluded from the MRA, the change to component assumed life cycles and the associated 24% average increase, but to query how the 40% reported earlier was reduced, and to criticise the decision not to make provision for disabled adaptations
- You may wish to comment on the suggestion of capital grants to pay for backlog repairs after 2010.

Core and non-core services

On the HRA ring fence, it is proposed that it ‘...should continue and, if anything, be strengthened’. The detailed proposals are for a separate account to record all landlord expenditure (revenue and capital) and the transfer of resources between HRA and General Fund. Where services have a wider benefit than just to HRA residents, costs should be apportioned. This is one of the aspects of the paper where the precise implications will depend on the details of the proposed principles to be established. It is possible that ALMOs may have a differing view to their councils on the detailed principles, with ALMOs welcoming a strengthening of the ring fence, and councils concerned about the implications for their General Funds.

- (CLG question 1): Do you agree with the principles set out in paragraph 3.28 of the consultation paper?
- (CLG question 2): You may wish to draw attention to particular ring fence issues.

Standards

HQN welcomes the statement of continuing commitment to the Decent Homes standard contained in the consultation paper, and the proposal to recognise the omission of lifts and common areas. The paper seems to imply that these items would not be formally added to the Decent Homes standard, but would be added to calculations of necessary expenditure. Again, it would be necessary to see the detail of how available funding will be allocated between councils before the full implications would be clear. For example, will councils which have rejected the current alternative options for achieving Decent Homes receive the necessary funding through this route?

- (CLG question 3): You may wish to comment on the proposal to fund lifts and common areas, and to fund backlogs through capital grant.

The paper’s fourth question invites comments on the direction of travel on standards, and invites alternative funding mechanisms ‘that would be neutral to government expenditure’.

The move to improve standards (given that it is matched by funding) is surely welcome. It may be appropriate to make the point that this is only sustainable if funding continues to be made available to support it. In our view, the rest of the proposals are such that few alternatives to capital grant will be available. You may wish to consider asking for greater flexibility to carry resources from one financial year to the next than has usually been the case for capital grants (although it is unlikely this will be granted), and to appeal for administration to be as straightforward as possible.

- (CLG question 4): You may wish to comment on the direction of travel on standards, whether the funding mechanisms will work, or make alternative suggestions on funding.

Local authority leaseholders – service charges and sinking funds

It is of little surprise that CLG has been considering the problems of leaseholders who are liable for large individual contributions to Decent Homes and other major works programmes. Particularly in the large cities, leaseholders, some of whom may already be facing negative equity, have been receiving very large bills. However, there are no proposals here on those who have already bills, or are due to receive them shortly.

For the future, CLG intends to consider ways to better inform prospective leaseholders of their potential future liabilities, and to allow for contributions to future works to be added to the sale price. There is little detail of the thinking behind these suggestions: for example, would the addition to the sale price be at the council's discretion or the purchaser's? For how many years in advance will such contributions be made? Mortgage lenders will need to be convinced that the value of the dwelling being bought will be increased by the amount of this contribution, and will still be reluctant if the works are scheduled for too far into the future.

- You may wish to comment on the suggestion that prospective leaseholders should be better informed on their potential liabilities, or that the sale price should have the costs of future works added.

The paper suggests that the use of sinking funds for leaseholder contributions would be desirable, and proposes to eliminate any doubt about whether they are lawful through new legislation. It asks whether there should be an obligation on councils to provide sinking funds. For those councils and ALMOs with large proportions of leaseholders amongst their residents, the cost of administering such funds could become significant. You may want to consider seeking confirmation that administrative costs would be deductible from interest added to funds. Those who remember the early days of Right to Buy will be pleased to know that sinking funds are now exempt from the need to deduct tax from the interest paid.

One difficulty which has arisen with sinking funds in the past is the situation where the contributions made to date are inadequate to pay for necessary works. Leaseholders have been indignant at being asked to pay the balance of costs when they have been paying into the sinking fund.

- (CLG question 5): You may wish to comment on barriers to the use of sinking funds, or whether there should be a legal obligation to provide them.

Improvements to the current system

Whilst the chapter *Options for fundamental reform of the system* commences by considering the less radical option of improvements to the current system, it is clear that this is not being seriously considered.

Self-financing options

Debt redistribution

The government's preferred option is self-financing, with a one-off redistribution of debt between councils. This would of course, in large measure, make more explicit the process which already happens now, with those councils in Negative Subsidy helping to pay the debt charges of those councils with larger historic debt. However, the most obvious barrier to this approach is the hostility of debt-free councils to being required to take on new HRA debt. We appreciate that many councillors are proud of their council's debt-free status, and regard it as a sign of prudence. In this context, it will be difficult for the government to achieve the consensus it believes would be necessary to implement the proposals in the absence of primary legislation.

- You may wish to object to the principle of taking on debt (or additional debt).

Calculation of 'affordable debt'

The debt each council could afford to service would be calculated through applying discounted cashflow techniques to a 30-year business plan. This would produce a Net Present Value (NPV), and is similar to the methodology used for stock transfer valuations. The intention appears to be that each council's business plan would be based on assumed levels of management, maintenance, and rent, as for the current subsidy system, but with future stock investment requirements taken from the council's stock condition survey. The assumptions on management and maintenance will presumably reflect the increase indicated by the government's research. In such a system, the need to invest in major repairs to the stock will be critical to the calculated affordable debt. In our experience councils have stock condition surveys of varying qualities and ages, based on different specifications, sample sizes, assumed component life cycles and so on. Surveys have been undertaken by various firms of surveyors and in some cases by in-house staff. How will the government satisfy itself that the need to spend shown in each business plan has been produced on an equal basis? What will it do if the national total of surveys is greater than the 24% uplift its research suggests?

Surveyors are used to giving warranties to housing associations and their funders. Given the importance of this data to the calculation, councils are likely to require these also, and, unless an in-house survey could be insured, an external survey is likely to be necessary to

achieve this. Against this, it would doubtless be difficult to successfully claim against such warranties. We would in any case, expect the government to require as a minimum, that in-house surveys are externally validated.

The discount rate selected will make a significant difference to the NPV. How will this be set? It would be difficult enough if every council were taking on the whole amount of debt now; in practice, those whose debt is to increase will have a combination of new and existing debt, and those who are to have debt redeemed will each have their own existing rate. In all cases, the council's debt profile will indicate future movements in its pooled rate, subject to assumptions about prevailing rates in future years. Once a rate is selected, should interest rates prove much higher in practice than assumed, especially in the early years, will the government assist councils with the problems this would cause?

What is not clear is whether any assumption about future real increases in income and expenditure will be made, and this will also have a significant impact on the NPV. The subsidy system has assumed larger increases in rent than in expenditure, hence the increasing surplus on the system (lower interest rates have also contributed). Will the calculation of debt be based on similar assumptions throughout 30 years? Will real reductions in costs be assumed in line with public expenditure assumptions? The answers to these questions will have a significant impact on the debt assumed to be affordable and whether this position is 'neutral' for the government, or for individual councils. (The latter will be more difficult to achieve if revised management and maintenance levels are included.)

The future of rents will clearly be critical. The paper says 'this consultation document is not... proposing any changes to rent policy'. It acknowledges that the future of rent policy would have to be determined before debt redistribution. It would be complex, but not impossible, to set long-term goals and model assumed rents moving to target for each council over an extended period. The danger of building long-term assumptions into the model has been demonstrated by the government's decisions to amend the rent increases which would have arisen from the system for both 2008/09 and 2009/10. Such flexibility would no longer exist after debt restructuring.

The NPV approach, especially if the calculation includes assumed real increases in net income, may give rise to annual deficits in the early years for some councils. Under existing legislation (in the absence of balances to cover them), such deficits would be unlawful. The existing accounting arrangements for the HRA are based on the legislative framework as it currently exists. If these proposals are implemented, these would need to be reviewed. For example, the current dispensation around MRA/depreciation may change, with unintended consequences.

- (CLG question 6): You may wish to comment that the detail of the calculation of the NPV will be crucial, and that in the absence of this, it is difficult to commit to a definite view on the proposals

- (CLG question 7): You may wish to comment that should the assumptions upon which the NPV is based prove to be too optimistic, especially in the early years, it will be extremely difficult for these to be managed, and help from the government is likely to be necessary
- You may wish to comment that the accounting arrangements would need to be agreed as part of this process.

Future government demands

Should the government make new, currently unforeseen demands of councils in the future, the settlement will not have taken these into account. The paper therefore states that there would be a mechanism to re-open the debt settlement in these circumstances. This would risk replacing one complex system with another. There would also be the risk that if the assumptions turned out, with the benefit of hindsight, to have worked in councils' favour, that the calculation could be 'replayed'. We would be less confident that this would happen if the opposite were the case. We would suggest that in order to avoid a new, complex system, new demands from the government should be funded by new grants.

- You may wish to comment that the proposal to keep powers to repeat this exercise should be severely restricted, perhaps to dealing with severe difficulties arising from assumptions which, with hindsight, prove to be errors.

ALMO and Private Finance Initiative funding

The national level of debt quoted by the government appears to omit Round one and two ALMOs' debt, which is expected to be added to the Subsidy Capital Financing Limit after 2010/11.

The paper does not make an explicit statement about ALMOs' new Decent Homes funding under the new system. We assume that the proposed capital grants would be used for this funding, but those ALMOs still due to receive funding may wish to seek confirmation.

On PFI funding, the options would be that the NPV calculation could include expenditure equivalent to the funding due to be paid in future years, or it could be paid as revenue grant each year.

- You may wish to comment that satisfactory arrangements for future ALMO and PFI payments will be essential.

Debt restructuring

The paper acknowledges that it will be a complex matter to ensure that there is no net effect on the council's General Fund. The main issue here will be the impact on the overall interest rate of redeeming or taking on new debt. This will be particularly complex where market debt, rather than the Public Works Loan Board, is involved. The paper commits to working through the details of these issues before implementation.

It is proposed that the current set-up within each council, with pooled debt between the HRA and General Fund, and rules governing the amount charged to the HRA akin to the Item 8 rules, be continued. However, it is acknowledged that this approach may not prove to be consistent with the objective of ensuring a net nil impact on the General Fund. This will clearly need to be worked through as part of the overall work in this area.

- (CLG questions 8 and 9): You may wish to welcome the commitment to ensuring no net impact on the General Fund, and the undertaking to pursue further work to achieve this.

One issue which does not appear to be considered by the paper is that of principal repayments of debt. At present most councils with HRA debt do not make provision for its repayment, on the grounds that the interest is covered through the subsidy system. The NPV calculation, if perfectly correct, would allow sufficient funds for debt repayment, but this repayment would typically be loaded towards the end of the 30-year period. With interest no longer covered by HRA Subsidy, chief financial officers will have to consider whether the repayment loaded towards the final years of the 30-year business plan are satisfactory, or whether provision should be made earlier. If earlier, there will be no provision in the business plan for this. This may be a matter for CIPFA to consider, as publishers of the Prudential Code.

The government's future position

We know that at present, the government makes a surplus from HRA Subsidy. The consultation paper signposts 5% increases in Management and Maintenance Allowances, and 24% increases on MRA, plus the costs of the promise to avoid General Fund costs of debt restructuring. At present, at least some of these costs are not yet known. Does the government intend to sacrifice some or all of its current surpluses from the HRA Subsidy system to do this, or to recoup its costs through assumed future increases in net rents?

- You may wish to express a view as to whether the proposed additional expenditure should be met from assumed increased net rents in the future, thus increasing the NPV.

Borrowing under self-financing

Despite hopes that council housing might be removed from the definition of public sector spending (in line with other European nations), the paper re-affirms that it is within the public sector. Should new borrowing exceed that assumed in the self-financing calculations, this would potentially cause problems for the government. It proposes therefore to limit such 'additional' borrowing. It seems to us that such limitation will in part defeat the benefits of the proposed reforms. It is clear that it will not be acceptable to have no restrictions, but perhaps some leeway could be allowed 'as of right'.

- (CLG question 10:) You may wish to comment on the proposal to limit future borrowing to that assumed in the 30-year business plan.

Perhaps optimistically, the paper asks respondents to advise what funds, which could be used to fund debt, might be raised during the currency of the 30-year business plan.

- (CLG question 11): You may wish to predict the source of available income to fund additional borrowing during the 30 years from the start of the proposed system.

Managing risk under self-financing

The paper suggests that 'there will be a need to build capacity in some councils' to manage risk. It states that the Tenant Services Authority (TSA) would set the framework for managing risk, and have strong regulatory powers. We would comment that the TSA will need to demonstrate that it has sufficient knowledge of the sector to regulate it. Regardless of regulation, ALMOs and councils should be in no doubt that any problems which arise will theirs to deal with.

- You may wish to comment on the assumption that councils may not be familiar with managing risk, and on the proposed regulation by the TSA.

Capital receipts

The proposal here is to abolish receipts 'pooling', but to require the 75% of receipts currently pooled to be reinvested in housing. As the paper points out, this would be consistent with the principles of the rest of the proposals. It makes it clear that capital resources allocated by the government would be reduced to take account of the loss of the pooled receipts. Effectively, receipts would be retained where they arose, with unfettered local decisions about 25% of them, and local decisions within the constraint of a requirement to spend them on housing for the remaining 75%. The paper queries whether the balance between new supply and investment in existing dwellings should be prescribed.

- (CLG questions 12-14): You may wish to comment on the proposal to allow councils to retain 100% of receipts, to reduce capital resources allocated by the government by an equivalent amount, and to require 75% of receipts to be invested in housing. You may also wish to comment on whether the balance between new supply and existing dwellings should be prescribed.

Disabled facilities in local authority housing

The paper proposes that councils could use their retained capital receipts for this purpose. In our experience, at present at least, Right to Buy sales have all but ceased. This will not help those councils for whom receipts are inadequate. We comment on this further below, in the context of Equality Impact Assessments.

- You may wish to comment on the assumption that capital receipts can be used to finance these.

Implications for self-financing for transfer and ALMO policy

The paper states that in the past, extra funding for transfer (through debt write-off) and ALMOs has 'reflected a view about the benefits of separating the LA strategic role from delivery'. Although it does not explain why this policy has apparently been abandoned, the paper says that 'self-financing would create a level playing field between transfer and retention'. It is silent on ALMO funding, presumably as it is already well-known in the sector that Round 6 was the final round.

- You may wish to comment on the decision not to support transfers through debt write-off in the future.

Implications for ALMOS

ALMOs will doubtless wish to welcome the statement that 'the government sees a strong future for ALMOs'. Reference is made to broadening and enhancement of the basic ALMO role, including managing other landlords' stock, 'where this makes sense'.

- ALMOs may wish to welcome the government's continuing commitment to their futures.

Local Housing Companies

The paper refers to the existing pilot programme of 14 councils, and states that it is of continuing relevance.

Equality Impact Assessments

The paper seeks input on whether any of the changes would have a disproportionate impact on any particular groups of people. It would clearly be extremely difficult to demonstrate such impacts: if the rules apply equally to all authorities, they presumably apply equally to all their residents. In HQN's view there are, however, two areas where changes or lack of changes could have an adverse impact on some groups.

It is clear that the aids and adaptations services currently offered by councils and ALMOs already differ significantly across the country in terms of waiting times and access to funding. The proposals covering use of capital receipts to pay for disabled facilities could mean that councils which were still selling properties under Right to Buy would be better placed to meet the needs of their disabled residents than other councils. This could further exacerbate the differences in service and have an adverse impact on disabled people.

Another area where there could be a disproportionate impact is the lack of support for leaseholders facing large bills. Many ALMOs and councils which have carried out customer profiling of leaseholders have established that leaseholders are often elderly and have increasing levels of disability. Such leaseholders may already be in need of support

in their homes and facing difficulties in selling their homes because of prospective purchasers' fears about future bills. The lack of proposals for helping elderly and disabled leaseholders could lead to them facing more disadvantage.

At the local level, authorities will need to carry out their own Equality Impact Assessments of how they propose to implement changes to ensure there is no direct or indirect discrimination against any groups or individuals.

- (CLG questions 15-17): You may wish to comment on whether there are disproportionate effects on any group of the proposals, what the effect is, and how evidence could be gathered.

Some additional detailed notes

These notes are intended to provide some additional detail on some financial aspects which may not be familiar to all readers.

HRA Subsidy system

The system works on the basis of a 'notional' HRA; that is, the government makes its own assessment of the income and expenditure which each council should achieve and require in its HRA.

Like the real HRA, the key components of the notional HRA are:

- Rental income
- Management costs
- Day-to-day maintenance costs
- Major repairs costs
- Capital financing costs.

In addition to these major items, the system also takes account of interest receipts from the few remaining mortgages, and rental payments on long-term leased dwellings. It is assumed that service costs are met from service charges, and any other income available to the HRA (such as shops).

Where the calculation results in an assumed deficit, the council receives that amount in subsidy; where it is a surplus, the council must pay this amount into a national pool (Negative Subsidy).

For every council, rental income exceeds assumed management, maintenance and major repairs. The key to whether a council receives subsidy or pays into the national pool is the amount of debt recognised by the system. The councils with the largest debt tend to be those in the large cities.

It follows from the above, that the cost assumed for each Council for management, maintenance and major repairs (referred to within the subsidy system as the allowances for each of these items) is significant, as it will directly impact on the amount received or paid.

The assumed rental income will similarly impact on the position of each council. The subsidy system is gradually moving the 'Guideline Rent' (assumed rent for subsidy purposes) to converge with the average 'Formula Rent' (colloquially, the 'target rent') for each council.

A further measure of rent is relevant; the 'limit rent' (colloquially, the 'rent cap') is the maximum average rent the council can charge without losing subsidy on the rent rebates (Housing Benefit) it pays (the cost of lost subsidy has to be charged to the HRA). The definition of rent for these purposes includes a proportion of 'unpooled' service charges; this proportion is gradually reducing to nil.

Discounted cash flow (Net Present Value) calculations

It is clear that £1,000 today is worth more than £1,000 in ten years' time, but how much more? What if the comparison were £800 now or £1,000 in ten years' time? Discounted cash flow is a method of assigning a present value to future cash flows. The 'discount rate' (assumed time value of money) is key to the calculation. If the amount each council could borrow was set using this technique, and every detail of the 30-year business plan (including cost of borrowing being equal to the discount rate) were included, the debt would be paid off at the end of the final year.

Interest rates and treasury management

Councils which have debt operate a loans pool. Typically, there will be a number of different loans, almost always on fixed rates, and for varying timescales (most councils aim to have some loans due to mature in the near future, some in 5-ten years, some 10-15 years and so on.) The various rates of interest being paid on the different loans together give rise to a combined 'pool rate' which the council will charge its General Fund. However, the rate of interest charged to the HRA (the 'Consolidated Rate of Interest'), whilst it reflects the local cost of borrowing, is calculated in accordance by rules laid down by the government.

The majority of council debt is with the Public Works Loans Board (PWLB). The PWLB is run by the government to source borrowing for councils at the optimum rate. On previous occasions that the government has redeemed council debt (for example, on stock transfer), it has sought to have no impact on the pool rate, by redeeming the appropriate proportion of each PWLB loan. This gives rise to complications where councils do have debt from other lenders (usually referred to as 'market debt'); if not all of the loans within the council's loans book are part-redeemed, this will impact on the pool rate.

Another implication of the early redemption of debt is that breakage costs are incurred. Similar to an individual paying a penalty for exiting a fixed rate mortgage early, councils are required to pay a premium on early redemption (or sometimes will receive a discount for early redemption when this is in the lender's favour). The government is proposing to cover these costs arising from the restructuring of debt which is core to its proposals.

Consultation response checklist

- You may wish to welcome the 5% increase in assumed management and maintenance at the national level, or perhaps comment that it is inadequate
- Although this paper does not comment on how the assumed management and maintenance costs will be distributed, you may nonetheless wish to comment on this
- You may wish to request that revised allowances be introduced from 2010/11, pending any future amendment to the subsidy system
- You may wish to welcome the proposed addition of items previously excluded from the MRA, the change to component-assumed life cycles, and the associated 24% average increase, but to query how the 40% reported earlier was reduced, and to criticise the decision not to make provision for disabled adaptations
- You may wish to comment on the suggestion of capital grants to pay for backlog repairs after 2010
- (CLG question 1): Do you agree with the principles set out in paragraph 3.28 of the consultation paper?
- (CLG question 2): You may wish to draw attention to particular ring fence issues
- (CLG question 3): You may wish to comment on the proposal to fund lifts and common areas, and to fund backlogs through capital grant
- (CLG question 4): You may wish to comment on the direction of travel on standards, whether the funding mechanisms will work, or make alternative suggestions on funding
- You may wish to comment on the suggestion that prospective leaseholders should be better informed on their potential liabilities, or that the sale price should have the costs of future works added
- (CLG question 5): You may wish to comment on barriers to the use of sinking funds, or whether there should be a legal obligation to provide them
- You may wish to object to the principle of taking on debt (or additional debt)
- (CLG question 6): You may wish to comment that the detail of the calculation of the NPV will be crucial, and that in the absence of this, it is difficult to commit to a definite view on the proposals

- (CLG question 7): You may wish to comment that, should the assumptions upon which the NPV is based prove to be too optimistic, especially in the early years, it will be extremely difficult for these to be managed, and help from the government is likely to be necessary
- You may wish to comment that the accounting arrangements would need to be agreed as part of this process
- You may wish to comment that the proposal to keep powers to repeat this exercise should be severely restricted, perhaps to dealing with severe difficulties arising from assumptions which, with hindsight, prove to be errors
- You may wish to comment that satisfactory arrangements for future ALMO and PFI payments will be essential
- (CLG questions 8 and 9): You may wish to welcome the commitment to ensure no net impact on the General Fund, and to undertake further work on this
- You may wish to express a view as to whether the proposed additional expenditure should be met from assumed increased net rents in the future, thus increasing the NPV
- (CLG question 10): You may wish to comment on the proposal to limit future borrowing to that assumed in the 30-year business plan
- (CLG question 11): You may wish to predict the source of available income to fund additional borrowing during the 30 years from the start of the proposed system
- You may wish to comment on the assumption that councils may not be familiar with managing risk, and on the proposed regulation by the TSA
- (CLG questions 12-14): You may wish to comment on the proposal to allow councils to retain 100% of receipts, to reduce capital resources allocated by the government by an equivalent amount, and to require 75% of receipts to be invested in housing. You may also wish to comment on whether the balance between new supply and existing dwellings should be prescribed
- You may wish to comment on the assumption that capital receipts can be used to finance these
- You may wish to comment on the decision not to support transfers through debt write-off in the future
- ALMOs may wish to welcome the government's continuing commitment to their futures

- (CLG questions 15-17): You may wish to comment on whether there are disproportionate effects on any group of the proposals, what the effect is, and how evidence could be gathered.

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