Appendix B

Governance Considerations

There are three elements of governance and accountability for the HIC:-

- within the HIC structure;
- within the Council structure; and
- within the relationship between the Council and the HIC.

The Directors of the HIC are assumed to be officers unless the Council decides to appoint one or more external directors to supplement the board with commercial skills as Non-Executive Directors (NEDs). The Directors of the HIC are responsible under the Companies Acts and Articles of Association for the management of the HIC's business. The HIC will have a business plan which the Council as shareholder will approve and the Directors will be responsible for ensuring that the plan is delivered. This will include:

- decisions on land acquisition and valuation
- entering into contracts for the construction of the housing development (construction and professional team)
- agreeing the terms of funding
- marketing strategy
- management and maintenance arrangements in relation to the rented properties.

The production of this business plan is detailed within the Implementation Plan in Section 12 of the main report.

The Companies Act 2006 sets out the main general duties of directors. A director owes his/her general duties to the HIC. This means that only the HIC will be able to enforce them.

The statutory duties of a director are to:-

- act within powers;
- promote the success of the HIC;
- exercise an independent judgement;
- exercise reasonable care, skill and diligence;
- avoid conflicts of interest;
- not accept benefits from third parties; and declare any interest in a proposed or existing transaction or arrangements within the HIC.

There may be perceived conflicts of interest between the directors as officers of the Council and their directors duties owed to the HIC. However, such should not be an issue in practice. The director's duties are owed to the HIC (or shareholders) and the only proposed shareholder will be the Council. In particular the duties to promote the success of the HIC and to exercise independent judgement can be exercised with due regard to the wishes of the Council as sole shareholder.

However, there are other boundaries which the directors must not stray over: these are primarily around insolvent trading. This particularly relates to fraudulent and wrongful trading. In the course of a winding up of the HIC, if it appears that any business of the HIC has been carried on with the intent to defraud creditors or for any other fraudulent purpose the liquidator can seek a Court declaration that anyone who was knowingly party to the fraudulent business make a contribution to the HIC's assets (Section 213 Insolvency Act 1986). Furthermore, on the application of a liquidator, the Court may require a contribution to the assets of the HIC from a person who is or was a director where the HIC has gone into insolvent liquidation and the person knew or ought to have concluded that there was no reasonable prospect that the HIC would avoid insolvent liquidation (Section 214 Insolvency Act 1986).

In addition to the general duties of directors there are other specific duties in the Companies Act 2006 particularly those in relation to the accounts of the HIC.

The Council as shareholder will appoint the Board of Directors. As sole shareholder the Council will technically be able to protect its interests by appointing or dismissing directors as it sees fit. However, in pursuance of good governance the Council will enter into a Shareholders Agreement with the HIC. Such an Agreement will be used to set down the base parameters within which the HIC will operate particularly with regard to its business plan and budget. Notwithstanding its powers at sole shareholder the Council will also use the Agreement to set down parameters for the HIC taking on risk and those decisions which will require the consent of the Council as shareholder as a consequence (e.g. entering into material contracts and obtaining funding).

Resourcing

Given the scale of the initial development programme officers have assumed that the HIC will initially require one/two Project Director(s) to direct and manage the programme with support services such as finance, HR, IT, Legal etc. provided by the Council (and charged to the SPV). This could be a secondee from the Council, at least initially.

The Programme Director(s) will be responsible for procuring technical services such as cost consultants and valuers to act in a development management role – these costs are incorporated within the business model on a fee per site basis. The Programme Director would also be responsible as the client for the procurement and delivery of the development programme; property sales; the procurement of management services for the completed rental stock, and setting and maintaining service standards; and for reporting on progress and performance to the Board.

As the programme develops and properties come into management there may be a case for recruiting additional staff within the HIC. and for separation of the above client roles between development and property management functions.

The HIC may also consider a partnership with external parties such as developers or a housing association. In these cases, the external party might act as the HIC's development agent for individual sites and potentially also take ownership of elements of the affordable housing where it may have a specialism (e.g. shared ownership housing); the HIC would retain the affordable rent housing and take rental/sales risk and profits from the market units. The relatively small portfolio currently under consideration may mean that the Council considers this unnecessary now, but this remains an option for larger more complex sites.

Use of surpluses within the company

Where surpluses arise within the company it may consider paying a dividend to its shareholder (the Council). This would be a decision for the board when it reviews the company's performance against its business plan targets and looks forward to assess future spend requirements and the need to use surpluses to maintain a reserve and/or pay down debt. The decision would need to take into account the risks and mitigation measures described below.

Risk Management

Company directors have a responsibility to the company for ensuring that the company remains a "going concern". In some instances the company may operate at a loss in the early years but as a going concern, the company would be assumed to be able to continue in business for the foreseeable future and able to realise its assets, discharge its liabilities, and obtain refinancing (if necessary) in the normal course of business. This would be managed through regularly reviewing performance against the business model and ensure there is sufficient contingency and risk mitigation in place.

There are a number of material risks that the Council must consider within the HIC. Management risk will not be unfamiliar to the Council, as they are similar risks that the Council manages through its own HRA housing stock. However, added to this is the development risk which the LHC takes on in each site.

Key strategic risks that the Council must consider on a scheme of this nature are:

- Build costs are higher than expected;
- Cost of funds increases above that considered in the financial assessment;
- Year 1 income is below expectations as a result of late completion of units;
- Annual income is less than expected as a result of market conditions, for example House Price Inflation is less than CPI, or there is a slower than predicted turnaround of voids;
- Annual operational costs are higher than expected.

This could lead to the HIC being unable to meet its debt repayment schedule and so the business model must incorporate adequate risk contingency based on a robust risk assessment which is reviewed annually to take account of market changes and performance against targets. These and other risks, their impact and the action expected to be taken are to be considered in more detail in the Risk Register. The development of this risk register is detailed within the Implementation Plan in Section 12 of the main report.

The Council may consider sharing risk with a private sector partner, thus forming a joint venture company (JV).

The answer to whether the Council wishes to share risk in this way possibly lies in:

- the objectives of the Council
- its risk appetite (compared to a wholly owned subsidiary)
- the extent to which the Council wishes to involve third party capital and thereby spread risk but pay for it.
- the size of the programme of development to be undertaken

Certainly the JV approach has become more prevalent for long term phased development and regeneration projects. The reasons for this include the control that a joint venture gives (especially considering the market in today's economic climate), flexibility to change course over time, a more certain way in the long term of obtaining overage, reducing holding costs of development by swapping land for shares together with the obvious injection of private sector capital. Typically local authority JVs rely on a phased supply of development opportunities over a number of years.

The main disadvantage of this approach is that the Council would necessarily be ceding absolute control over the company. Decisions within the JV would have to be by agreement. The private sector partner would seek returns on its investment, potentially developer/returns if it were to take developer risk, therefore diluting the SPV's profit.

The JV approach is one that the Council could consider at a later stage, possibly undertaking large developments by way of a joint venture between a separate SPV and a private sector partner (especially developments which need significant risk capital).

This can easily be accommodated within the "tree" structure that has been set out in paragraph 7.2 of the main report, whereby each project is ring fenced. So, for example, a private sector equity investor could be brought into one project (i.e. one SPV) without the potential to taint the remainder of the corporate structure.

A further long term option is for the Council could also consider selling shares in one or more of its SPV companies at a point in the future if it wishes to raise funds for future development and expansion of the business.

In terms of an exit strategy, the Council could achieve a clean exit from its participation in a company limited by shares, by way of sale of those shares on the open market to an investor at a future date, transferring the lettings business as a going concern. An alternative would be for the vehicle to sell the dwellings and then for the Council to carry out a solvent liquidation of the vehicle. Either of these routes would achieve an orderly exit.