PART 2 – CONFIDENTIAL FACTS AND ADVICE

MD2267
Title: **Heart of Harrow (LB Harrow) Housing Zone – Former Cumberland Hotel**

Information may have to be disclosed in the event of a request under the Freedom of Information Act 2000. In the event of a request for confidential facts and advice, please consult the Information Governance team for advice.

This information is not for publication until the stated date, because:
It contains commercially sensitive information the disclosure of which might prejudice the commercial and business interests of GLA Land and Property Limited. It also contains legally privileged information.

Date at which Part 2 will cease to be confidential or when confidentiality should be reviewed:
31 March 2020, although specific consideration should be given as to whether the legally privileged advice contained herein should be withheld for a longer period.

Legal recommendation on the grounds of keeping the information confidential:

Under section 43 of the Freedom of Information Act information is exempt if its disclosure would, or would be likely to, prejudice the commercial interests of any person (including the GLA). Under section 42 of that Act information is exempt if its disclosure would, or would be likely to, involve the disclosure of information that is legally privileged.
These are both qualified exemptions, meaning that information captured under sections 42 and 43, can only be withheld if the public interest in withholding it outweighs the public interest in releasing it.
The information below contains information relating to confidential assessments of the scheme and unit costs of housing relating to the intervention and proposed Housing Zone funding; the proposed structure and terms of Housing Zone funding; and confidential information relating to the proposed recipient of the funding. This is all commercially sensitive information, the disclosure of which would, or would be likely to, prejudice the commercial interests of GLAP, and other organisations specified below. While there is a public interest in understanding the circumstances in which public money is provided to other bodies, it is considered that in these circumstances the public interest lies in maintaining the exemption and withholding the information.
If this information is considered for release pursuant to the provisions of the Environmental Information Regulations 2004, this information should be considered exempt information under regulation 12(5)(e) – where disclosure would adversely affect the confidentiality of commercial or industrial information where such confidentiality is provided by law to protect a legitimate economic interest.
The information below also contains legally privileged advice relating to the above, particularly in connection with the contractual arrangements and State Aid. It is also considered that, in the circumstances, the public interest lies in maintaining the exemption and withholding the information.

Legal Adviser - I make the above recommendations that this information should be considered confidential at this time

Title: Senior Associate - Property & Planning Law **Date:**

Once this form is fully authorised, it should be circulated with Part 1.

Confidential decision and/or advice:

1. Confidential information

Appraisal

1.1 Savills undertook project due diligence using a Housing Zones (HZ) Development Appraisal Toolkit and supplementary information provided by the borrowers. This due diligence also involved a benchmarking analysis of costs and revenues and general appraisal assumptions. Savills deemed both the benchmarking and appraisal assumptions to be appropriate and within market expectations.

1.2 Savills identified the following key risks to delivering the scheme:

- Planning.
- Restrictive covenants on the site.
- Third party ownership of part of the site which is required to implement the planning consent as proposed.

1.3 A resolution to grant planning consent for the proposed scheme was granted in December 2017 following the period during which due diligence was undertaken by Savills.

1.4 The restrictive covenants are historic and appropriate insurance will be put in place to mitigate any risk.

1.5 The borrowers have agreed a commercial position with respect to the third-party land and the drawing of loan funding requires that an agreement will be in place with the third party prior to the drawing of funding the effect of which is to extend GLAP's right of step in over this land for the purposes of exercising its security.

Repayment

1.6 The borrowers will draw down and repay the loans as profiled in the cash flow set out in Annex 1. Loan 1 is expected to draw down in March 2018, peak in December 2020, start repaying from January 2021 and fully repay by December 2021. Loan 2 follows a not dissimilar profile although the timing is concertinaed given the significantly reduced number of sales in the affordable element of the development.

Security

1.7 Security for loan 1 comprises a debenture granting a fixed charge over land and work in progress, together with a floating charge over all JV assets. The security package also provides for GLAP to have step in rights in respect of the development in the event of default by the borrower. In respect of loan 2, GLAP will have the benefit of a first, fixed charge over the leasehold interest in the affordable element of the development (the RP is given this interest following the transfer of its freehold interest in the site to the JV). Step in rights similarly apply to this loan in the event of default by the borrower. The loan agreements require security to be underpinned by a Red Book land valuation and the certification of work in progress by an independent monitoring surveyor.

Financial covenants

1.8 The loan-to-cost ratio must not exceed 60% for both loans. For the purposes of this calculation, development costs are defined as the value of land plus the value of work-in-progress (discounted by 10%).

1.9 The loan to gross development value must not be more than 55% for both loans.

Interest rate (creditworthiness and collateral)

1.10 Interest Rate Setting Board (IRSB) indicatively offered rates as set out below on 20 December 2017 (rates to accurately reflect the EC reference rate at the point of contracting):

1.11 Loan 1 (£25.501m) to the JV was offered an indicative rate of 3.53% predicated on a "Weak" borrower and "High" collateral. The creditworthiness assessment reflects the fact the JV is a without recourse SPV with limited assets. The collateral assessment reflects the fact that land and work in progress will be secured through a debenture and has sufficient value to remain within prescribed loan covenants.

1.12 Loan 2 (£17m) to the RP was offered an interest rate of 2.00% predicated on a "Strong" borrower and "High" collateral. The creditworthiness assessment reflects the fact that the RP is a regulated entity. The collateral assessment mirrors the position in respect of the JV.

Value for Money – comparison to other HZ loans

1.13 The £42.501m loan facility will support 204 homes which equates to approximately £208k per home. This means the project is relatively highly geared in terms of GLAP's commitment. However, while a high amount of gearing creates additional lender risk, this risk is reflected in the indicative interest rate offer. The below table shows the proposed loan facility in comparative terms against existing HZ loans [1].

Contractually committed Housing Zones loans in order of value for money:

Scheme	Counterparty	Loan facility (£)	No. of homes	Investment per home (£)
Blackwall Reach	Swan	£50m (recycled)	1,477	£34k
Britannia Music Site	Durkan	£25m	354	£71k
Cambridge Road	Swan	£29.1m	274	£107k
Wembley Parade	Anthology	£34.5m	195	£177k
Former Cumberland Hotel	**Central Harrow/Origin**	**£42.5m**	**204**	**£208k**
Northolt Road	South Harrow / Origin	£25.3m	116	£218k
Hale Village Tower	Anthology	£55.1m	250	£221k

Conclusion

1.14 Savills' report concludes "[o]verall the assumptions and agreements between the parties for this development seem reasonable and allow the developers to deliver a larger scheme with higher levels of affordable housing than usually provided for schemes of this size. It also enables the acceleration of housing delivery". The report also states that the risks identified have in Savills' view "been sufficiently mitigated". GLA Housing and Land officers approve these findings and deem them significantly robust to justify providing funding for this scheme.

2. Financial comments

2.1. The first loan of £25.5m to the Central Harrow LLP joint venture is expected to be drawn down in March 2018 and to be repaid by December 2021. The second loan of £17m is expected to have a similar profile.

[1] The table shows the number of homes at the time each loan agreement was signed.

2.2. The security GLAP have over the £25.5m loan is a debenture granting a fixed charge over land and work in progress together with a floating charge over all the joint venture assets. GLAP also have step in rights in the event of default by the borrower. The security over the £17m loan is a first, fixed charge over the leasehold interest in the affordable element of the development.

2.3. The loan to cost ratio must not exceed 60%. The loan to development value must not be more than 55%. These ratios apply to both loans.

2.4. The joint venture has been offered an indicative interest rate of 3.53% for the £25.5m loan, predicated on a 'weak' borrower and 'high' collateral. The registered provider has been offered an interest rate of 2% for the £17m loan predicated on a 'strong' borrower and 'high' collateral. Actual rates will be set with reference to the EC reference rate at the point of contract.

2.5. In arriving at the interest rates for this intervention, the IRSB has relied on the following interest rate grid as their margin for risk. This is a widely-used state aid grid, which is also used by the Homes and Community Agency (HCA).

Creditworthiness		Collateralisation	
	High	Normal	Low
Strong (AAA-A)	0.6%	0.75%	1%
Good (BBB)	0.75%	1%	2.2%
Satisfactory (BB)	1%	2.2%	4%
Weak (B)	2.2%	4%	6.5%
Unsatisfactory (CCC and below)	4%	6.5%	10%

2.6. In common with all commercial lenders, GLAP sets its rates according to the following principle:

Offered Rate = Lender's cost of funds + margin for risk + costs

2.6.1. For lender's cost of funds, the State Aid Matrix or the PWLB (our default source of finance) rates are used, whichever is the greater.

2.6.2. For margin for risk, the Interest Rate Communication risk matrix is used, which has been specifically issued by the EC to comply with state aid; we have taken a professional view that it is indeed a reasonable framework (in the expectation of building up a diversified portfolio); as the portfolio evolves, we will keep this position under review, including from time to time commissioning external research, but would not expect to go below these suggested spreads.

2.6.3. The IRSB has decided that in relation to costs they will set this at the level of GLAP's legal fees.

2.7. For the lender's cost of funds, we use the cost of GLAP borrowing funds from the DCLG. The rate may fluctuate with movements in the EC reference rate as DCLG charges GLAP 60 basis points on top of the EC reference rate, taking GLAP to be a counterparty of Strong Creditworthiness and High Collateralisation. Interest rates are fixed at point of borrowing in relation to DCLG and GLAP Housing Zones Financial Transactions.

2.8. The Chief Investment Officer or Assistant Director Group Finance certifies that the pricing principles above have been complied with and (following consultation with Legal Services) that the other terms and conditions of the loan are structured in a prudent commercial manner, in line with our MoU with DCLG.

2.9. Given that we judge our rate to be calculated in a commercial manner, and that we anticipate our contracts will contain the normal provisions found in commercial loans, we are satisfied we are meeting the requirements of the MEIP:

2.10. GLAP lends "on terms and conditions which would be acceptable to a notional private lender operating under a normal market economy situation".

2.11. As an overlay, where we are dealing with companies with actively traded bonds, we would compare our rates to look for large discrepancies and seek to understand these.

3. Legal comments

3.1. Reports prepared by external solicitors summarising the key terms of the two loan agreements are attached to this Part 2.

State Aid

3.2. It is GLAP's intention that the terms and conditions and the interest rate for these proposed loans to the counter-parties are in line with those available on the open market. On that basis GLAP proposes to rely upon the Market Economy Investor Principle (MEIP), which permits public bodies to lend to enterprises/economic undertakings on terms and conditions which would be acceptable to a notional private lender operating under a normal market economy situation. Providing the principle is properly complied with then no state aid arises as no advantage is conferred on the loan recipients.

3.3. The onus when relying on MEIP is for the public authority to justify (and if required prove) that its loan has complied with MEIP requirements. These include:

3.3.1. That the terms/conditions of the loan and interest rate are market terms for the particular circumstances of each transaction;

3.3.2. That a notional market lender would have lent to the particular loan recipient (e.g. they were creditworthy); and

3.3.3. That the terms of the loan properly reflect the security being offered.

3.4. External lawyers have advised the GLA as to whether the methodology for calculating a market interest rate set out in the EU Commission's Communication in relation to setting reference and discount rates (2008/C 14/02) (the Interest Rate Communication) is acceptable in respect of state aid compliance. Their advice is that this methodology is widely used by public authorities in circumstances where they are making a market loan under MEIP but, in doing so, they are adopting a risk based approach; by applying the methodology it is probable that in most circumstances the loans would be state aid compliant, though there is still a risk that not all will be.

3.5. Circumstances where unlawful state aid may still arise when using the proposed methodology include:

3.5.1. No market lender would have lent to the loan recipient (e.g. bad credit score or insolvency concerns);

3.5.2. Not applying the methodology as a notional market lender would (e.g. accepting poor security but scoring it as strong security);

3.5.3. Not commercially assessing and/or applying the credit scoring; or

3.5.4. In effect treating the application of the methodology as a process, rather than a tool to determine the correct market rate for the particular circumstances of each loan.

3.6. External lawyers have advised that the following steps should be followed by the GLA to help mitigate against these risks:

3.6.1. Ensure that the credit rating is current and from an independent respected organisation;

3.6.2. Properly consider any security being provided (including what is the market value of the assets being secured and order of priority of its security); and

3.6.3. Undertake a more detailed review of difficult cases, particularly if there are concerns that a notional market lender would never lend (e.g. insolvency concerns about the borrower).

3.7. GLA officers have confirmed that the above mitigating measures have been followed and external lawyers have been instructed to prepare and negotiate the funding contracts and security documentation for GLAP, including the incorporation of any provisions required to ensure compliance with state aid rules.

3.8. External lawyers have also advised on the ability of GLAP to adopt a fixed interest rate for its loans and whether this complies with the MEIP/state aid requirements. Their advice is that a loan with a fixed interest rate is acceptable under MEIP providing it complies with the requirements set out in paragraph 2.9 above. To rely upon this GLAP would require evidence that at the time the loan was granted a notional market lender would have offered the relevant fixed interest rate to that borrower in identical circumstances.

3.9. It should be noted that the Interest Rate Communication itself requires a variable interest rate. External lawyers have therefore advised that where a fixed rate loan is to be offered, the GLA would also require evidence from a suitably qualified commercial/financial adviser that a rate calculated using the Interest Rate Communication would also be offered in identical circumstances by a notional market lender for a fixed interest rate loan (or advise on the higher margin which a notional market lender would require). Such evidence would have to take into account the creditworthiness of the borrower, security offered and the identical circumstances of the proposed arrangement. External lawyers have advised that advice from an independent external financial adviser would provide the strongest evidence. However, GLA officers have confirmed that, in relation to the proposed loan to the counter-party, this evidence has been provided by suitably qualified internal advisers. In so doing the GLA is accepting the risk that if the loan is ever challenged on state aid grounds, such internal sign-off may not be viewed as sufficient objective evidence that the fixed interest rate is a market rate.