Report to: Housing Services Management Team
Report from: [redacted]

Subject: Guardian "Costing & Charging" Project – Investment of Residents' Monies

Date: 22 Aug 2007

Purpose

The purpose of this report is to present progress to date with the above project, which forms part of Guardian's Operational Plan

I HAVE THIS REPORT

Attached is an accompanying report commissioned as part of this project that outlines Anchor's legal position in relation to current practice and future proposals.

This report presents proposals and recommendations for further development of this project.

A decision is sought from HSMT, which may also need to extend to EMB

Approval to extend the project deadlines is sought as the scope of the project has changed. It is expected that the project may run to December 2007 in order that it runs in tandem with the review of the management proposition and management fee.

Introduction

A review of the way in which Guardian pays interest to Residents estate funds was commissioned following the Guardian Cost Base Review in November 2006.

The present method is to use the Lloyds base rate less 1% (this is taken to cover administrative costs). This rate of interest is applied to all of the estate reserve funds in bulk as Guardian uses its exemption as a housing association (s.42 Landlord & Tenant Act 1987) not to have to hold reserve funds in separate trust funds.

The 1% taken for the purposes of administration is not represented as a business benefit to Guardian, but is a corporate charge for which there is no defined cost shown within the Guardian business plan.

The cost base review highlighted the fact that, because estate funds are held alongside other Anchor monies, they are likely to be performing significantly better than base rate. This means that there is an unquantified business benefit to holding reserve funds in this way as (taking July 07 figures)

Residents enjoy an interest rate equivalent to 4.5% (base rate 5.5%) whereas some of Anchor's investments enjoy a significantly higher return.

The cost base review led to the commission of a project within Guardian to look at the benefit to Guardian arising from the difference in interest paid to Residents and the performance of Anchor's investments, which include Residents reserve monies.

As a quick example, assume that Anchor's monies perform as high as 9%, based upon the inclusion of Residents' monies in the sum of £10.3M.

9% x £10.3M = £927,000 less 4.5% £927,000 - £463,500 = £463,500

In this example, Residents still get an attractive rate of interest, but the true benefit to Guardian is the difference between interest earned and interest paid. Compared to the income derived from Guardian's management activities, this sum of money is of significant benefit to Guardian.

Preliminary discussions with [redacted] and [redacted] led to agreement in principle that it would be fair to identify the benefits of Guardian's reserve fund investments within Guardian's business plan.

Before progressing any further, professional advice via Anthony Collins solicitors was sought, with the following questions being asked:

1.1. In particular, Anchor has asked us to:

1.1.1. advise it on whether there are any restrictions on the way in which it can invest money held in a reserve fund;

1.1.2. advise it on whether there are any financial services regulations, in addition to those that would apply where the monies were held in individual trust funds, it would have to comply with if it were to invest the reserve fund in a diverse portfolio rather than hold the money in individual trust funds; and

1.1.3. advise it whether it could take some form of commission or charge from the interest earned through investing the reserve fund monies in this way to cover management costs/overheads of managing the fund.

The report in relation to these questions is attached and findings are addressed in this report.

Definitions

Within this report there is a mixture of terminology when talking about Anchor and Guardian.

Anchor is used when quoting external advice as this makes sole reference to the legal entity that is Anchor Trust.

Anchor is also used when making reference to the investment portfolio as this mainly comprises Anchor's monies, which also include monies derived from Guardian Residents' reserve funds.

Guardian is used when both referring to Residents or when referring to activities undertaken by Guardian Management Services in the management of each estate. A useful rule of thumb is to consider is whether Residents view their relationship to be with Guardian or with Anchor – this is reflected in the terminology used.

Extract of the Executive Summary to Anthony Collins Report

- There are strong arguments in support of the position that Anchor holds the reserve funds on trust for its residents.
- As trustee Anchor is required to act in the best interests of its beneficiaries (i.e. the residents). It is therefore inappropriate to seek to find an arrangement that offers a "win/win" solution; by doing so Anchor would not be acting in the best interests on residents.
- In our view, on the questions, Anchor could achieve its aims if it used depreciation rather than sinking funds. But we are well aware that though this does deal with the questions, there are wider issues that would in our view mean depreciation was not an answer.

To a large extent, the above answers Anchor's questions. Anchor should also note: -

- Anchor needs to consider whether, as an exempt charity, it can undertake investments that are deemed not suitable for it to carry out as a trustee of the reserve fund.
- Where Anchor holds the reserve funds money on trust, on the face of it Anchor could be involved in carrying on regulated activity under FSMA. Carve-outs or exemptions may apply but we would need Anchor's finalised proposals giving a

closed list of the investment and activity types involved before being able to advise conclusively. A carve-out that could be of particular interest is a carve-out for trustees; for the avoidance of doubt, this in our view cover's Anchor's existing use of the reserve funds, but could not extend to its proposals.

- Where Anchor holds the reserve funds on trust it is not entitled to charge a commission for investing those funds. However, it may recover its reasonable and proper expenses.

IS 1% REASONABLE

Summary of Findings

Whilst Guardian doesn't hold Residents monies in individual trust funds, any monies held on corporate account are deemed to be held in constructive trust.

As trustee, Guardian must act in the best interests of the Residents, which **rules out the possibility of pursuing the original objectives of the project to share the benefits of investment** (as laid out in the simple example in the introduction).

Anthony Collins has also been asked for a view on any liability upon Guardian to pay any back-dated interest to Residents accounts in relation to the possibly higher rate of interest earned compared with the lower rate of interest paid.

On this latter point it may be very difficult for Guardian to identify the rate of interest actually earned by the element of the total Anchor fund that includes Residents' monies. Whilst the overall portfolio may have performed at a much higher rate, this will be made up of a combination of a variety of investments all earning at different rates.

SEE ACCOMPANYING E-MAIL TO COUNTER THIS

Any requirement for Anchor to be regulated for the purpose of investing Residents' monies clearly seems to be exempted in relation to the current position. However, this would need to be a consideration if any changes are proposed, although any change would be of no benefit to Guardian if the position of a constructive trust were accepted.

Proposals

1. It would be reasonable to continue with the current practice of holding Residents monies alongside Anchor's monies and investing as part of Anchor's wider portfolio.

   In adopting this method it can be strongly argued that Anchor is exempt from any need for FSA regulation.

The only amendment suggested is that the rate of interest paid to Residents accounts is more reflective of the actual performance of the investment. Also, the deduction for administrative costs is made more quantifiable and not simply a rate of 1%

2. Another proposal may be that Residents monies are held separately in a single "Anchor" account. This will make the balance of Residents monies clearly definable and the rate of interest paid to these monies would simply be the rate paid to that account (and will assume that the most appropriate/beneficial account is chosen).

   In addition to holding Residents monies in a separate account, there will be a need to identify the reasonable costs incurred in the management of those monies and not simply use a 1% deduction as above.

3. The final proposal would be to hold Residents monies in individual trust accounts. The benefit to this is that the balance to each individual account is easily identifiable and will potentially support the way in which Guardian will be required to account when balance sheet accounting is introduced.

   The downside is that this will involve greater administration, which would need to be recovered from the management fee, plus Residents don't benefit from more generous interest rates.

   The biggest point for consideration, however, is those estates with depleted funds that are at risk of falling into deficit – the move to separate trust accounts will lessen the flexibility to offer options to resolve, which means that any shortfall will need to be billed immediately (causing potential hardship to Residents)

Recommendations

In taking Proposal 1 Anchor should not benefit financially from the way it invests Residents monies and, although the current practice is difficult to quantify in any way, it should not be a business benefit to Guardian.

In addition Anchor will need to consider the way in which these reserve monies are represented within the Annual Report: Accounting Balance Sheet. This has already been alerted to [illegible] via [illegible].

Residents will benefit from a reasonable rate of return, which can be benchmarked against the returns available on the high street (so Proposal 1 is as beneficial to Residents as Proposal 2).

Proposal 3 incurs additional administration, so is not of equal benefit to Residents.

Proposal 1, in essence, advocates very little change to the current processes and is simple to administer.

It is recommended that Proposal 1 is accepted and any changes are completed within the extended deadline to December 2007.

It is also recommended that a dialogue with Corporate and Shared Services takes place to agree the internal charges, the agreement for which reflects the acceptance of Proposal 1

Ends