Freeing Housing Associations

Better financing, more homes

Christopher Walker

Freeing Housing Associations

Better financing, more homes

Christopher Walker

Policy Exchange is the UK's leading think tank. We are an educational charity whose mission is to develop and promote new policy ideas that will deliver better public services, a stronger society and a more dynamic economy. Registered charity no: 1096300.

Policy Exchange is committed to an evidence-based approach to policy development. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

Trustees

David Frum (Chairman of the Board), David Meller (Deputy Chair), Theodore Agnew, Richard Briance, Simon Brocklebank-Fowler, Robin Edwards, Richard Ehrman, Virginia Fraser, Krishna Rao, George Robinson, Robert Rosenkranz, Charles Stewart-Smith and Simon Wolfson.

About the Author

Chris Walker is Head of Housing, Planning and Urban Policy. Before joining Policy Exchange, Chris worked as a civil servant for twelve years, in the Government Economic Service, for a number of departments including the Department for Communities and Local Government, the Department for Work and Pensions, and HM Treasury. He has six years experience working on housing policy and analysis, including affordable housing and housing markets. He has an MSc in Economics from York University and a BA in Economics from Reading University.

© Policy Exchange 2014

Published by
Policy Exchange, Clutha House, 10 Storey's Gate, London SW1P 3AY
www.policyexchange.org.uk

ISBN: 978-1-907689-87-1
Printed by Heron, Dawson and Sawyer
Designed by Soapbox, www.soapbox.co.uk

Contents

	About the Author	2
	Acknowledgements	4
	Introduction	5
	Executive Summary	9
1	A New Category of Housing Association, Independent of Historical Housing Grant	16
2	Government Equity Investment in New Affordable Homes, Instead of Capital Grant	29
3	Government Encouragement, Support and Guidance for Housing Associationsto Build More Market Homes for Sale	41
4	Requiring and Supporting Inactive Housing Associations to Become Active	47
	Appendix A	54
	Appendix B	58

Acknowledgements

I would like to thank the wide range of individuals and organisations that shared their ideas, perspectives and insights during the course of this work. Special thanks are owed to Peter Williams for reviewing this paper, as well as Adam Morton and Pete Redman for providing their expertise and ideas. Any errors and omissions remain, of course, my own.

I am most grateful to our sponsors, Genesis Housing Association and Winckworth Sherwood LLP for their support.

Introduction

There is a serious and growing housing problem facing England that requires urgent action. That is why it is rising up the agenda of politicians across the spectrum. In short, nowhere near enough new homes are being built: by the latest official estimate, at least 232,000 homes need to be built every year simply to meet future demand – measured by the projected growth in household numbers.[1] Far more, however, are needed to make an inroad into the backlog. Insufficient homes have been built for at least a generation – the country has not come anywhere close to meeting the 232,000 target in any single year since 1988, and the cumulative shortfall during this time is at least one million homes. Only by building 300,000 homes a year for a prolonged period could that backlog be eliminated as well as future demand be met. Last year, just 112,000 homes were built and the average over the last 10 years has been 137,000 a year, barely half the figure required.[2]

Just 47,000 affordable homes[3] a year are being built currently, mostly delivered through housing associations[4] (around 2,000 of them are built by local authorities). While this might be enough in the context of meeting the future growth in households most in need, there are already 1.7m households on local authority waiting lists.[5] To meet this backlog, many more affordable homes are needed and many more market ones.

The tragedy is that, within the housing association sector, there is certainly sufficient financial capacity to build many more affordable and market homes than are currently being built. Indeed, the sector as a whole could deliver as many as 100,000 affordable and market homes each year. But that capacity is being curtailed by a byzantine system of regulatory rules and financial constraints. This is exacerbated by a significant number of housing associations that build few or no new affordable homes.

The housing association sector reported a surplus of £1.9bn in 2013,[6] sufficient to build around 45,000 affordable homes if used alongside current government grant levels, contributions from private developers (so-called section 106), and sustainable borrowing. However, the sector could be making a much bigger surplus – of around £3.0bn a year – if housing associations were given more freedom to use their balance sheet capacity through strategic asset management, were encouraged and supported to build more market homes for sale, and had access to cheaper debt finance. Although some of this is already happening on a small and piecemeal basis, it needs to happen across the piece and with more rapidity.

The current system of government funding, through modest levels of capital grant is no longer fit for purpose. Despite reductions in capital grant funding from 2010, it still costs the Exchequer £1.1bn a year[7] at a time when the public finances remain tight. The grant levels on offer to housing associations are no

1 Office for National Statistics (ONS) Household projections (2008–2033). www.gov.uk/government/statistics/household-projections-2008-to-2033-in-england

2 DCLG Live table 209 House building: permanent dwellings completed, by tenure and country. www.gov.uk/government/statistical-data-sets/live-tables-on-house-building

3 Throughout this report, the term "affordable" encompasses homes for social rent - i.e. traditional "social housing", affordable rent, other submarket rent products, and affordable home ownership.

4 DCLG Live table 1012 Affordable housing starts & completions funded by the Homes & Communities Agency and the Greater London Authority. www.gov.uk/government/statistical-data-sets/live-tables-on-affordable-housing-supply

5 DCLG Live table 600 Rents, lettings and tenancies: numbers of households on local authorities' housing waiting lists1, by district2: England 1997–2013. www.gov.uk/government/statistical-data-sets/live-tables-on-rents-lettings-and-tenancies

6 HCA 2013 Global Accounts of Housing Providers. www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

7 www.gov.uk/government/news/35-billion-deal-to-build-homes-and-drive-local-growth

longer commensurate with the burdens and risks that grant places on them. In short, the grant deal currently on offer is no longer attractive to housing associations. A zero grant model where the government invested generous levels of repayable equity in housing association homes, instead of providing grant with its multitude of restrictive conditions, could be a more attractive deal to both parties. Furthermore such a model could, ultimately, cost the government nothing in terms of public expenditure because the investment could be treated as a financial transaction, and would almost certainly provide better financial support to housing associations.

This report demonstrates how, with a sector-wide annual surplus of £3bn a year, and a better government funding model supplementing it, housing associations could be building or acquiring 60,000 affordable homes a year: 40,000 for affordable rent and 20,000 for shared ownership; instead of 45,000 affordable homes currently. This would also generate substantial housing benefit savings growing at a rate of £5m a year (£5m in year 1, £10m in year 2, and so on).[8]

However, building more affordable homes alone will not bring down the waiting lists quickly. Building more market homes too would improve affordability and reduce the pressure on the social sector. Between 2000 and 2010 the waiting lists grew from 1.0m to 1.7m households.[9] This is not because affordable house building fell (it did not), but because affordability in the wider market grew so much worse. Housing associations should therefore be encouraged to build more market homes not just to help cross subsidise their affordable housing building, but to make a significant contribution to market supply and increase longer run capacity.

Housing associations are currently planning to build around 7,500 market homes for sale a year from 2015.[10] Yet, they could be building as many as 22,500 market homes for sale, on top of affordable housing delivery of 60,000 homes, without being overly exposed to housing market risk. Housing associations could also eventually be building 15,000 homes for market rent each year, funded by institutional investor private equity, so that housing associations would help spearhead institutional investment in the private rented sector. This could happen if we allowed private investors to invest equity in housing associations more easily.[11]

The sector could therefore deliver around 100,000 homes a year: 60,000 affordable *and* 40,000 market. Such affordable housing supply numbers are not pie in the sky. Octavia Housing Association has recently laid down a "3%" challenge to housing associations, to build enough affordable homes to grow their stock by 3% a year. [12] If all housing associations committed to this they would build at least 60,000 affordable homes a year and possibly as many as 80,000. 60,000 is a realistic ambition. The National Housing Federation (NHF) too has recently set out a longer term vision for housing associations to build 120,000 affordable and market homes a year.[13]

This report explores four areas to enable the housing association sector to deliver 100,000 affordable and market homes a year. By chapter:

1. the economic regulation and system of allocations attached to historical grant, that are constraining the ability of housing associations to deliver new homes through their balance sheet, and a lack of incentives for local authorities to supply the land to build new affordable houses on;

8 Assumes average savings of £1,600 a year per home, 63% of tenants on HB, & household formation of 10%

9 DCLG Live table 600 Rents, lettings and tenancies: numbers of households on local authorities' housing waiting lists1, by district2: England 1997–2013. www.gov.uk/government/statistical-data-sets/live-tables-on-rents-lettings-and-tenancies

10 Inferred from the financial projections set out in the HCA's 2013 Global Accounts of Housing Providers (p39 table 16): the average receipt 2015–18 is £1,535m which, divided by £200,000, gives circa 7,500 homes. www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

11 An interesting development is the Mutuals Redeemable Shares Bill, making its passage through Parliament. http://services.parliament.uk/bills/2013-14/mutualsredeemableshares.html

12 www.insidehousing.co.uk/associations-urged-to-up-their-housing-stock-by-3/7003835.article

13 NHF An Ambition to Deliver http://s3-eu-west-1.amazonaws.com/pub.housing.org.uk/An_ambition_to_deliver.pdf. See also www.theguardian.com/housing-network/2014/jun/09/social-housing-associations-build-sale-rent-future

2. the way the government funds affordable housing, given the current affordable rent model remains expensive (£1.1bn a year), which incurs high and unsustainable levels of housing association borrowing, provides a level of grant that is unattractive to housing associations, affordable rents that can be a misnomer, and imposes unacceptable financial risks on housing associations in the context of welfare reform;
3. why only a few housing associations are building market homes for sale, in order to support surplus positions to cross-subsidise affordable housing, and the issue of prudent market risk exposure; and
4. why there are so many inactive housing associations,who do not develop or acquire new build affordable homes.

Addressing these is ultimately about increasing financial capacity (namely surpluses and the ability to borrow) and increasing the likelihood that surpluses get used to develop or acquire new build affordable housing. It is likely that central and local government are not going to have funds to increase expenditure on affordable housing due to continued fiscal constraints. The funds necessary to increase affordable housing supply have to come from elsewhere, ultimately from bigger housing association surpluses (and the fuller utilisation of these surpluses to build new affordable homes) and alternative private sector funding.

This vision for delivery is clearly ambitious. What is undoubtedly true is that some difficult policy changes are needed to make it happen. These changes also push the current boundaries of risk and control through the regulator. But the potential prize is great.

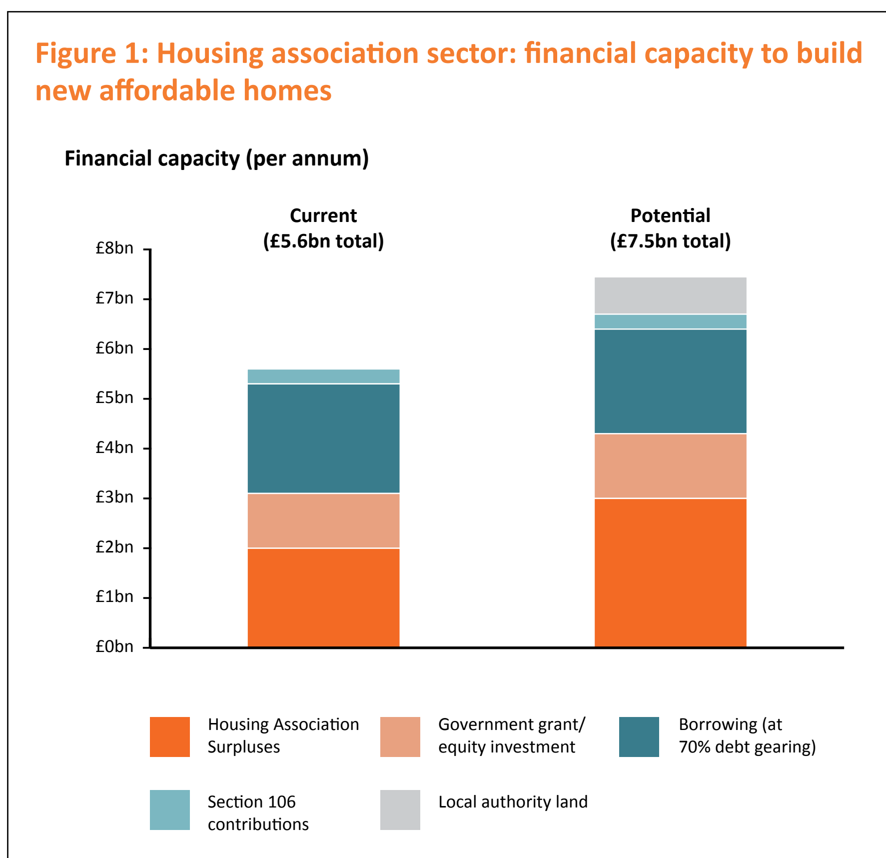


Figure 1: Housing association sector: financial capacity to build new affordable homes

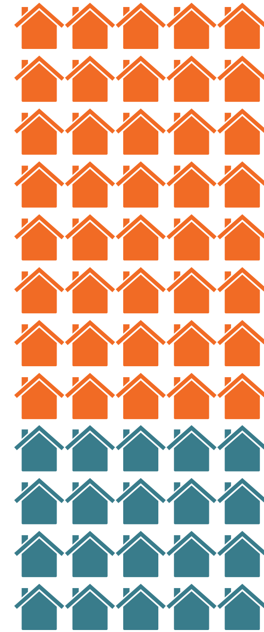
Homes that could be built

=1,000 affordable homes (£150,000 each)

=1,000 shared ownership homes (£75,000 each)

Current

Potential



Executive Summary

Background

- Nowhere near enough homes are being built in England. Last year, just 112,000 homes were built and the average over the last 10 years has been 137,000, barely half the figure required.
- Housing associations currently deliver around 45,000 affordable homes a year (England), as well as around 5,000 market homes for sale and rent.
- There are 1.7m housing households on local authority waiting lists. Bringing the waiting lists down will require both more affordable and more market homes to be built than currently.
- 1 in 6 of the existing homes in England are affordable homes.[14] Building just 50,000 affordable homes a year in the context of overall housing supply of 300,000 would maintain that 1 in 6.
- Housing associations are overwhelmingly charities. Most of them recognise the need and want to build more affordable homes to fulfil their charitable objectives.
- Housing associations have housing assets which at market value could be worth nearly £300bn, but currently they cannot fully utilise the value of these assets to build more homes.
- Housing associations certainly have sufficient financial capacity to build 60,000 affordable homes a year, which would generate substantial housing benefit savings.
- £45.4bn of historical housing grant is currently vested in housing associations, taxpayer money protected by regulation through ring-fencing arrangements.

Chapter 1

The relationship between historical housing grant, regulation, nomination rights and social rents is constraining new affordable housing supply from being delivered through housing association balance sheets. In our polling of Chief Executives and Finance Directors of large housing associations, 67% believed that historical housing grant should be written off with 70% of these saying their organisation would be willing to pay for it to be written off at a heavy discount and with payments spread over 30 years. Many housing associations want to build more affordable homes than they are currently building and see this is an integral part of their charitable mission. This chapter is about enabling them to do so. It recommends sweeping away the old, inefficient, byzantine system that creates a gridlock in new affordable supply, replacing it with a new deal benefitting housing associations, the government and tenants alike.

14 Throughout this report, the term "affordable" encompasses homes for social rent - i.e. traditional "social housing", affordable rent, other submarket rent products, and affordable home ownership.

- Housing associations wanting to develop or acquire new affordable homes by using their balance sheets and assets are hamstrung by the regulations that exist to protect £45.4bn historical grant, specifically the so-called "consent to dispose" requirement.
- This can hamper, sometimes even prevent, them from selling expensive social homes to build new ones on a more than one for one replacement basis, so increasing the number of affordable homes overall. The requirement also restrains their ability to borrow.
- The right of local authorities to nominate social tenants from their waiting lists for housing association homes, a right also attached to the presence of historical grant, also conspires to prevent housing associations from selling expensive social homes. This because local authorities can seek to deny the change of use (i.e. from social rented to owner occupied).
- If housing associations could use their balance sheets and asset-manage more freely, they could build an additional 5,000 affordable homes a year, on very conservative assumptions about extra borrowing.
- In our polling of Chief Executives and Finance Directors of larger housing associations, 67% of them felt that local authority nominations were are problem for their organisation, for various reasons.
- Submissions to our call for evidence also highlighted the issue of Local Authority nominations preventing housing associations from asset-managing their stock effectively *across* local authority boundaries (i.e. selling a social home in one local authority to build in another).
- The government is unlikely to ever recover the £45.4bn of historical housing grant money. The opportunity cost to the government of providing this is around £1.5bn a year.
- Housing associations cannot set their own rent policies. These are effectively dictated by central government and are also attached to the provision of grant historically.
- In our polling of Chief Executives and Finance Directors, 100% of them favoured greater flexibility to set their own rents *even* if it meant their rents on average could not increase.

Chapter 2

The way the government funds new affordable housing through capital grant is unsatisfactory to all parties concerned. For the government it remains expensive, at £1.1bn a year, at a time when the public finances remain tight. For housing associations it provides a lower level of grant that is unattractive: it incurs high and unsustainable levels of borrowing to plug the gap; the associated "affordable rents" can be a misnomer; and it imposes unacceptable financial risks on housing associations in the context of welfare reform – including direct payments and the benefits cap – which combined with (higher) affordable rents increases the risk of rent arrears. As a result affordable housing output could actually *fall* from 45,000 homes annually in the coming years. A grant model with only modest levels of grant is unworkable longer term. A new funding approach that recognises the fiscal constraints of the government needs to be found.

- Despite the reductions in capital grant funding with the advent of the affordable rent model, capital grant funding for affordable housing still costs £1.1bn a year, expenditure the government can ill-afford.
- The average capital grant rate offered under the affordable rent model, of £30,000, is often unattractive to housing associations because it is no longer commensurate with the obligations attached to grant funding – including the consent to dispose, local authority nominations rights, and rent controls in the form of affordable rents.
- The low level of grant means that housing associations now have to borrow over £100,000 per new affordable rented home to make up the shortfall,[15] a level of borrowing causing their debt gearing levels to rise towards the ceilings set out in their lending covenants.
- Affordable housing output is likely to start falling from current levels of 45,000 affordable homes a year within the next 10 years, as more and more housing associations approach their debt ceilings.
- The likely interest rate rises from 2015 will impact on housing association surpluses and hence their ability to invest in new affordable housing. The Homes and Communities Agency estimates that a rise in interest rates to pre crisis levels would reduce the sector wide surplus by £800m – which could translate into 10,000 fewer affordable homes a year.
- Affordable rents can be much higher than the social rents they are replacing and often aren't affordable for tenants. Combined with welfare reforms, including direct payment of housing benefit to tenants and the £500 per week benefits cap, there is an increased likelihood of tenants falling into rent arrears – a significant financial risk to housing associations.

Chapter 3

Too few housing associations are building market housing for sale to cross subsidise the delivery of new affordable homes – only a handful last year. There is a culture of risk aversion at the regulator level – driven again by the legitimate need to protect public assets – and within some housing associations themselves. This is preventing many thousands of new affordable homes being built each year out of the profits. More housing associations therefore need to embrace market housing. There should be a greater recognition that provision of additional market housing will ease the pressure on social housing. A new balance has to be struck in the risk: reward equation of building market housing for sale. The government has to signal its support for this as part of an integral strategy of reducing the waiting lists. The regulator too needs urgently to fulfil its role in helping housing associations to better understand the risks of more market activity and in managing their risk exposures.

- Only 25 of the top 50 housing associations built any market homes for sale in 2013/14, completing around 2,200 homes. 87% of that output was concentrated in the top 12.
- Housing associations are forecasting they will build around 7,500 market homes for sale a year from 2015 generating over £300m a year in profits, a sizeable portion (15%) of their projected overall surpluses of £2bn a year.

15 Including the additional borrowing through the conversion of social rented homes to affordable rented ones.

- The profit margin on development for sale is high – in the region of 20%. Selling a house at £150,000 can easily generate £30,000 of cross-subsidy to build or acquire a new build affordable home, similar to the average amount of grant currently.
- Building more market homes would improve affordability and reduce the pressure on the social sector. Between 2000 and 2010 the waiting lists grew from 1.0m to 1.7m households largely because affordability in the wider market grew so much worse.
- If all 71 of the very large housing associations replicated the market building levels of the top 12 cited, they would build around 17,000 market homes in an average year. This number would be 22,500 through extension sector wide, compared to the 7,500 forecasted.
- This could generate very substantial profits of up to £700m, enough cross-subsidy to build around 5,000 affordable homes (mainly in London) with sustainable borrowing levered in.
- The regulator has a legitimate concern about the exposure of housing associations to the housing market given the potential to put social housing assets at greater risk, but the potential prize is too great to ignore. There needs to be a better balance between the scale of building market homes for sale and risk, as well as much better risk management in place.

Chapter 4

There are too many inactive housing associations that don't build or acquire any new affordable homes, including a significant number of large housing associations with a housing stock of 1,000 homes or more. Stock transfer housing associations also appear to build significantly fewer homes than traditional housing associations, and this appears as a result of very significant debt refinancing constraints. This could be preventing them from building an additional 7,000 homes a year. Housing associations should be supported to build these homes by overcoming these constraints. There should be an expectation of housing associations that surpluses are used to build or acquire new affordable homes.

- A large number of housing associations aren't developing or acquiring any homes at all – around 1,250 out of 1,500, or 5 in 6, of them.
- This is mostly because the sector has a large tail of very small housing associations with fewer than 1,000 homes who, even on aggregate, have very limited financial capacity (about 4% of the sector's total).
- There are 339 housing associations with 1,000 homes or more that account for 96% of the sector total housing stock. A significant number of them – 86 – built no affordable homes in 2013/14.
- There is nothing to compel housing associations to build or acquire new affordable homes. Some lack the right incentives to do so, an "insider-outsider problem", analogous to that in the planning debate, could be leading to the reinvestment of surpluses for the benefit of existing tenants instead of new ones waiting to be housed.

- There can be good reasons why housing associations are inactive. For example, smaller housing associations probably face logistical issues and scale diseconomies mean they cannot build in a cost-effective way.
- A major blockage for stock transfer housing associations is that they cannot access new borrowing to fund new building without agreeing to the costly refinancing of existing debt.

Chapter 1 recommendations

To create a new category of housing associations, independent of historical housing grant:

- Any housing association would be able to apply for grant-independent status, but it would not be compulsory to do so. They would have to demonstrate a strong track record of new affordable housing delivery.
- Grant-independent status would allow the housing associations to buy out their historical grant from the government at cost, probably at a discounted rate and over 30 years, in return for the removal of regulatory restrictions on disposals of affordable housing assets, nomination rights of local authorities, and a loosening of rent controls bound to that grant.
- The strings attached to historical housing grant would be cut from year one. The new freedoms would include the ability of independent housing associations to sell empty social homes without the regulator's permission, so that they can utilise their balance sheet and asset-manage to build new affordable homes.
- Independent housing associations would have the right to set their own their own rents, but the limit rent increases for housing benefit, of CPI+1%, would remain. The limit rent increases would apply to the income of the housing association's *overall* affordable housing portfolio, not to rents of its individual properties.
- Independent housing associations would be absolved of most of their obligations to house local authority nominations. Housing associations and local authorities would be encouraged to agree land for nominations exchanges through regular negotiations, perhaps annually.
- A negotiations framework acting as a guideline, created in consultation with housing associations and local authorities, and their representative bodies, would be issued by the government to support this process.
- Central government financial support and incentives would also be given to local authorities to provide (or permission) land to housing associations for affordable housing, possibly through an enhanced New Homes Bonus mechanism.

Chapter 2 recommendations

Government equity investment in new affordable homes, instead of capital grant funding:

- New capital grant money should be replaced with time-limited government equity investment, as the main way for the government to fund new affordable homes for submarket rent and shared ownership. This could be treated by the government as a financial transaction and so would cost nothing in terms of public expenditure.

- The housing association/government ownership shares in the new affordable housing would be stipulated in trust for land and tenancy in common agreements. These shares would be flexible, decided on a case by case basis, and agreed through a bidding process similar to that for capital grant.
- The government would forgo the rental income on its ownership share, with the housing association charging up to market rent on its share, giving a genuinely affordable submarket rent level overall.
- There would be a requirement on the housing association to repay the government its equity stake within a 15 year period – either through the sale of the affordable home funded or through the wider asset management strategy, or through the rental surplus from the property that had accumulated over the 15 years.
- This would be a similar model to the new affordable rent to buy product, but with the cheap government loans replaced with the government equity stakes with overage – so that the government would capture its share of the capital gain as it does with Help to Buy.
- In the unlikely event of a fall in the housing market over 15 years, where the sale of an affordable home would incur a loss, the home could instead be temporarily let at market rent until the market had sufficiently recovered. The government would receive its share of the market rent (from year 15) to mitigate capital losses.

Chapter 3 recommendations

Government encouragement, support and guidance for housing associations to build market housing for sale:

- The Help to Buy scheme should be extended beyond 2020, but restricted to housing associations only, so that shared equity housing reverts to its original purpose as an affordable housing offer.
- Housing association market homes should be counted and valued within the assessments of bids for capital grant funding (or government equity investment), perhaps attaching an equivalency factor of ¼ of an affordable home, in recognition that additional market housing would ease pressure on affordable housing and provide funding for it. Both of these would have consequential savings in housing benefit expenditure, which features strongly in the government's value for money calculations.
- The regulator of housing associations, the Homes & Communities Agency, should issue guidance for housing associations so that they are aware of, and understand the risks, of increased housing market activity, in order to aid successful risk management.

Chapter 4 Recommendations

Requiring and supporting inactive housing associations to become active:

- The Affordable Housing Guarantee should be extended beyond March 2016, but its use restricted to stock transfer housing associations refinancing their existing debt.

- A new regulatory requirement should be introduced for non-independent, inactive, housing associations to explain how they are using their surpluses to build or acquire new affordable homes.

Box 1: The housing association sector in England – key facts and figures[16]

Sector profile:

- There are an estimated 1,500 housing associations in England
- There are 71 very large housing associations – owning more than 10,000 homes each – accounting for 54% of the sector's total stock.
- There are 339 large housing associations – owning more than 1,000 homes each – representing 95% of the sector's housing stock.
- There is a long tail of smaller housing associations. The majority have fewer than 250 homes.
- There are 167 stock transfer housing associations (and 172 traditional) in the biggest 339.
- Stock transfer housing associations own 1.2m homes, 44% of the sector total.

Stock profile:

- Housing associations own 2.7m homes, including: 2.0m homes general needs; 0.3m specialist housing for older people; and 0.1m supported housing for vulnerable people.
- The number of homes owned increased by 0.6% in the latest year (+0.7% general needs).
- 99% of the sector's housing stock now meets the Decent Homes Standard.

Sector financials:

- The housing association sector recorded a surplus of £1.9bn in 2013 and is projected to have an average surplus of £2.0bn a year over the next five years.
- Surpluses are concentrated in larger housing associations: the G15 of large housing associations had a combined surplus of £1.0bn last year, half the sector total.
- Many stock transfer housing associations are starting to report large surpluses – £0.6bn of the £1.9bn sector surplus in 2013/14 was generated by stock transfers.
- Historical grant vested in the sector stands at £45.4bn, reserves (equity) stand at £14.6bn, and total borrowing at £52.0bn. Debt gearing (debt as a % of equity including grant) stands at 86.8%.
- Interest cover, on the regulator's preferred measure, stands at 138.0%.

Building

- Housing associations reported that they developed or acquired 23,500 new build homes for affordable or social rent in 2013/14.[17]
- Developing and acquiring new affordable homes is by relatively few housing associations: the top 339 housing associations covered in the 2013 Global Accounts of Housing Providers reported developing or acquiring 23,300 (99%) of the total.

16 HCA 2013 Global Accounts of Housing Providers, HCA 2014 Statistical Data Return of Housing Associations www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf www.homesandcommunities.co.uk/sites/default/files/our-work/sdr_main_report_2014_full.pdf

17 Mainly "general needs" housing.

1
A New Category of Housing Association, Independent of Historical Housing Grant

The relationship between historical housing grant, regulation, nomination rights and social rents is constraining new affordable housing supply from being delivered through housing association balance sheets. In our polling of Chief Executives and Finance Directors of large housing associations, 67% believed that historical housing grant should be written off with 70% of these saying their organisation would be willing to pay for it to be written off at a heavy discount and with payments spread over 30 years. Many housing associations want to build more affordable homes than they are currently building and see this is an integral part of their charitable mission. This chapter is about enabling them to do so. It recommends sweeping away the old, inefficient, byzantine system that creates a gridlock in new affordable supply, replacing it with a new deal benefitting housing associations, the government and tenants alike.

Not all housing associations are the same. Many are developing significant tranches of new homes; many are at the forefront of financial innovation, of driving cost efficiencies, and maximising surpluses to reinvest in building new affordable homes. They embrace the marriage of increased commercial activity and fulfilment of their traditional, core, social purpose. These are all good qualities that should be encouraged across the sector. However, housing associations who are already delivering affordable homes, and who would like to deliver more through their balance sheets, are hamstrung by the strings attached to historical housing grant through the economic regulation – particularly, the requirement for the *consent to dispose* – and *local authority nomination rights.*

Consent to dispose

Housing associations are regulated by the Homes and Communities Agency (HCA) and as such they are bound by the HCA's 54 page Regulatory Framework.[18] The economic regulation within this exists primarily because of the presence of £45.4bn of historical housing grant money, and the legitimate need to protect it. This implicitly is not just because of the presence of tax payer money but also the public good it provides; including subsidised social or affordable rents, which for the government generate substantial savings to the public purse in the guise of reduced housing benefit expenditure. The annual housing benefit saving from

18 www.homesandcommunities.co.uk/sites/default/files/our-work/regfwk-2012.pdf

social rents and affordable rents (as opposed to higher market rents) is around £3bn a year.

Housing associations cannot therefore simply sell off their social homes when they become empty. They have to seek consent from the regulator to dispose of social or affordable homes. This in turn restricts the ability of housing associations to use their balance sheets and asset management through social housing sales to increase the number of affordable homes overall. The rules and regulations around the consent to dispose are set out in the Regulator's 74 page guidance document *Disposing of Land*.[19]

The consent to dispose will usually be granted by the regulator, for example, where it is clear the proceeds will be used to build or acquire new affordable housing. However, social housing transferred from local authorities cannot be disposed of without and Secretary of State's permission and it is generally assumed this would not be granted.[20] Moreover, some housing associations have said the process can be somewhat cumbersome and bureaucratic; if there is no general consent then a housing association will have to apply for consent from the regulator every time they wish to dispose of more properties.

Grant recycling

Housing associations also have to repay the historical housing grant vested in each affordable home they sell, unless they intend to re-use it to build a new one. In this case, they have to bid through the Recycled Capital Grant Facility (RCGF), though with no guarantee of success, and there are restrictions on how they can use the money. This too can hamper development:

> *"providers should be given greater control over the use of recycled capital grant to deliver new homes. At present providers wishing to spend recycled grant on new housing have to re-bid to do so…it increases regulatory burden and could slow down development."*
>
> [CFE submission]

Local authority nomination rights

Another major problem, highlighted in submissions to our call for evidence, lies in the system of allocations and the inherent attachment of local authority nominations rights to historical housing grant. Local authorities often have the right to nominate people from the waiting lists for housing association homes when they become empty (so-called nomination rights), in order to dispense of their homelessness duty. Data obtained from the Department for Communities and Local Government show local authorities nominated tenants for half of all housing association new lets and relets in 2012/13.

As a result, the scope of housing associations to asset manage is further stifled by the huge pressures to house people on the local authority waiting lists, which are now 1.7m households long.[21] This means that a housing association wishing to dispose of (i.e. sell) a social home when it becomes empty will come under immediate pressure to house a new household that has been nominated by the local authority. Building a replacement home usually takes more than a year, merely acquiring one a matter of many months, a luxury of time that often does not exist. Local authorities will naturally seek to prevent the sale of empty social homes in these circumstances.

19 www.homesandcommunities.co.uk/ourwork/consent-disposals

20 This is the so-called section 133 restriction. See *Disposing of Public Land*, p43.

21 DCLG Live table 600 Rents, lettings and tenancies: numbers of households on local authorities' housing waiting lists1, by district2: England 1997–2013. www.gov.uk/government/statistical-data-sets/live-tables-on-rents-lettings-and-tenancies

> *"Many housing associations are "stuck" with stock at social housing values. Unless a compelling plan of maintaining or growing social housing stock can be offered then local authorities can seek to deny change of use."*
>
> [CFE submission]

Furthermore, in a strategic asset management approach, a housing association will often want to dispose of a social home in one local authority in order to acquire or develop a new build affordable home in a different local authority. But the housing association will often be prevented from doing so by the local authority in which the sale is taking place. This is largely because of separate local authority waiting lists which engrain inflexibility. This obviously restricts the ability of housing associations to asset-manage across local authority boundaries.

> *"At present, housing associations face a range of constraints over allocations and tenure from local and national government. In particular, high levels of nominations from local authorities combined with rigid local authority boundaries mean providers are unable to make best use of our stock."*
>
> [CFE submission]

> *"Giving us greater flexibility over tenure and more freedom over allocations would support us to deliver the tenure of homes needed by local communities, balance our business strategies and react to market conditions. It would also support providers to allow customers to move across local authority boundaries and so support a more efficient use of the housing stock to meet need."*
>
> [CFE submission]

The existence of nomination rights has an implicit basis in the presence of historical housing grant, but local authorities will also often have provided land to housing associations for affordable housing. Stock transfers too, where local authorities have transferred their council housing stock to a housing association (stock transfer housing associations), will also have a high degree of nomination rights (i.e. 100%) as an implicit part of the arrangement.

A lack of asset management can of course also reflect a lack of awareness of – and an unwillingness to adopt – proactive strategic asset management among some housing associations, who can conventionally see asset management primarily as liability management and maintaining the stock at the decent homes standard.

Why these restrictions matter

Reflecting the restrictions on their ability to dispose of social housing assets, stock transfer housing associations have to value their properties for loan security purposes at 'Existing Use Value – Social Housing (EUV_SH)' which is equal around 30–45% of market value.[22] If this restriction did not apply, housing associations would be able to value all their stock at the higher 'Market Value Subject to Tenancy (MVSTT)' which equates to 60% of market value. This would effectively allow housing associations to value their stock at the higher MVSTT for loan purposes, releasing additional borrowing capacity for the development of new affordable homes. This extra borrowing capacity could be considerable for a number of housing associations.

22 The lower of two possible valuations for social housing due to restrictions in section 133 of the Housing Act 1988.

> *"Examples from five housing associations show lifting the restrictions could increase their borrowing capacity from between £60m and £320m, often doubling their existing capacity and significantly increasing the money they can invest in new homes."*
>
> [CFE submission]

The Homes and Communities Agency's Global Accounts of Housing Providers[23] sets out the global balance sheet of housing associations as it is currently accounted for: total equity is made up of historical housing grant (£45.4bn) and accumulated surpluses (£23.3bn), which implicitly incorporate EUV_SH, of £68.7bn.[24]

It is possible to work out the market value of housing association housing assets using the average equivalent market value of a social home in the housing association sector. An approximate valuation is the average preserved Right to Buy purchase price of £105,000,[25] although this is likely to contain cheaper properties. On this basis the total equity at market value is at least £280bn (2.67m[26] homes x 105k). The market value subject to tenancy – the basis on which debt could be secured – is around 60% of market value or at least £170bn.

The difference between the MVSTT and EUV_SH figures, of around £100bn, could reflect the extra borrowing capacity brought about if housing associations had the freedom to dispose of their social housing stock. However, it is not possible to assert the additional borrowing capacity would be the full £100bn, as some lenders already take this into account.

> *"Lifting restrictions on the way housing associations can dispose of, and in turn value, their properties … could release considerable additional borrowing capacity, which is currently artificially constrained. This proposal does not involve an 'accounting tick'… This would allow them to take on more debt to develop additional affordable homes."*
>
> [CFE submission]

> *"Restrictions on LSVT disposals and transfer agreement…do inhibit [stock transfers] from churning their assets in the way traditional HAs are now beginning to do. We strongly support a bigger role for asset disposals at market value, as a key ingredient in the funding mix for new affordable housing – especially in London and the SE. Amending s133 restrictions would enable borrowing against a higher value so increasing/unlocking some existing capacity."*
>
> [CFE submission]

The difference between the market value and existing use value figures – £280bn and £68.7bn respectively – illustrates the potential added financial capacity that could be extracted over a period of many decades to build new affordable homes, through the sale of empty social homes on the open market. This is what is often meant by using the balance sheet to build additional affordable homes through a strategic asset management approach. This is fundamentally about selling certain empty (void) social properties onto the open market (disposals) instead of re-letting them: namely social properties that are costly to run (to drive cost efficiencies) and/or have a market value significantly above the cost of building a replacement affordable home.

The inability of housing associations to asset manage their stock through sales is also reflected in part by the lack of disposals. There were around 217,000 relets

23 www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

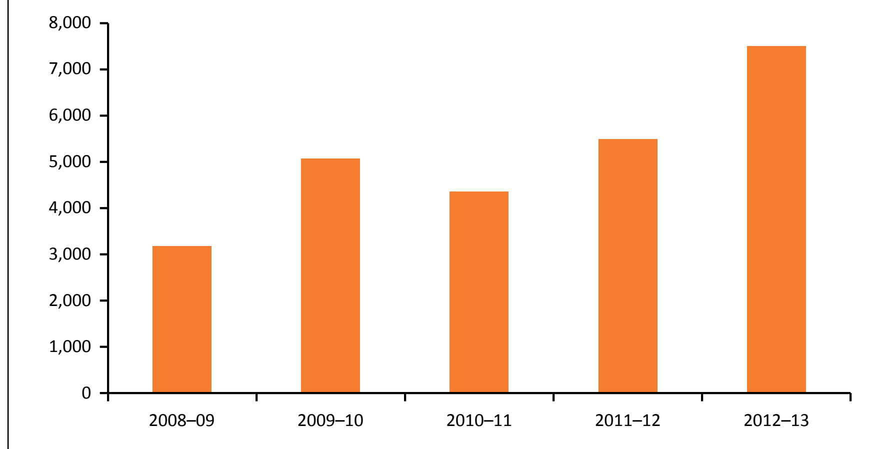
24 Including revaluation reserves – only a minority of the housing associations have these

25 DLCG live table 682: Social Housing Sales: Annual Financial Data on Right to Buy sales for England: 1980–81 to 2013–14 www.gov.uk/government/statistical-data-sets/live-tables-on-social-housing-sales

26 HCA 2014 Statistical Data Return of Housing Associations www.homesandcommunities.co.uk/sites/default/files/our-work/sdr_main_report_2014_full.pdf

by housing associations lets in 2012/13,[27] yet only 7,462 empty social homes were sold last year (excluding preserved right to buy), a tiny proportion (under 3.5%) of the overall turnover implied by the re-let numbers. Currently, social home sales have to be justified and agreed.

Figure 2: Social housing sales by housing associations (total, excluding preserved right to buy)[28]



Our 2012 report *Ending Expensive Social Tenancies looked at the issue of strategic asset management*.[29] The essence was that the sale of one home could enable the development or acquisition of more than one new affordable home, adding to the affordable housing stock overall. *Ending Expensive Social Tenancies* showed that 21.8% of all social properties (including local authority) were valued above the housing market median and that these were worth on average just shy of £195,000 each – the values now are likely to be at least £210,000 taking account of house price inflation since. The debt associated with these was estimated at £35,000 – above the average housing association debt of around £21,000, and so selling one of these would give net equity of £175,000. But total reinvestment capacity, without taking on additional debt would nonetheless be £210,000, enough to fund 1.4 new-build affordable homes with an average construction cost of £150,000.

This is also likely to be a conservative estimate as it does not include additional prudential borrowing that might be levered in, subject to the debt gearing constraints. With such additional prudential borrowing (35,000 x 0.5 = 17,500), enough money for 1.5 replacement affordable homes would be provided {(210,000 + 17,500) / 150,000 = 1.5}.

Of the 217,000 relets by housing associations last year, around 44,000 were because the previous tenant died or was evicted.[30] We can approximate that, in an average year, around 9,500 of these re-lets will be more expensive social homes (44,000 x 0.218). If we also take into account the modest number of social tenants who move, we can reasonably expect a bare minimum of 10,000 expensive social homes coming up for re-let each year, out of the 217,000. Selling these 10,000 social would therefore fund around 15,000 replacement affordable homes (10,000 x 1.5) without additional borrowing, an additional 5,000 affordable homes a year on net.

27 DCLG Social Housing Lettings, April 2012 to March 2013 www.gov.uk/government/uploads/system/uploads/attachment_data/file/252344/REVISED_20131023_CORE_statistical_release_2012-13.pdf

28 DCLG Live table 678 Annual Social Housing Sales by Scheme in England www.gov.uk/government/statistical-data-sets/live-tables-on-social-housing-sales

29 www.policyexchange.org.uk/images/publications/ending%20expensive%20social%20tenancies.pdf

30 DCLG Social Housing Lettings, April 2012 to March 2013 www.gov.uk/government/uploads/system/uploads/attachment_data/file/252344/REVISED_20131023_CORE_statistical_release_2012-13.pdf

More land for affordable houses

In order for extra affordable housing to be built, and for this to be genuinely additional to the housing being built currently, more land will have to be released into the system by local authorities. Without additional land, affordable housing competes with market housing – and housing associations compete with commercial developers – for the same fixed amount of land. Plainly, policy recommendations to increase overall housing supply are likely to be ineffectual without measures to fundamentally increase land supply to build the houses on.

It can be difficult too for housing associations to compete with the volume developers for land. The latter will always be able to offer more money because of the build-to-sell model. The Gross Value Added (GVA) will also be less than for a developer to the degree the housing is affordable as opposed to market. The returns to housing associations are not only lower but also slower, because their houses are predominantly rentals which pay back the investment over a longer period of time. Therefore, there needs to be a better deal – a special arrangement – between housing associations and local authorities to improve land provision specifically for affordable housing.

With well-over 200,000 housing association homes coming up for re-let each year the existence of local authority nomination rights to many of these homes reduces the incentive for local authorities to give their own land, or permission land, for new affordable housing to house people on their waiting lists.

The existence of local authority nomination rights also means the housing associations concerned have little say in the new tenants they take on. Local authorities can nominate difficult and antisocial tenants for housing association homes and this is a source of complaint for many associations affected. The housing associations themselves have little recourse. It adds to the financial risks and costs to housing associations in dealing with anti-social behaviour and through arrears, for which they are not adequately remunerated. Local authority nomination rights for existing affordable homes are, therefore, not properly priced.

> *"Most local authority development agreements include requirements for 100% nominations rights; alongside the absence of local lettings plan for most schemes, this impacts upon our ability to create mixed communities of individuals on low incomes, not just those in greatest housing need. If housing associations are provided with greater flexibility in allocating affordable homes to people who can genuinely afford them, this will thereby take pressure off housing benefit."*
>
> [CFE submission]

Local authorities also typically have the nomination rights to newly built affordable homes that are grant-funded, even if they haven't provided any land. This can reduce the appeal of building there for the housing association, where the likelihood of difficult tenants imposes extra costs and risks on them, or prevents them from pursuing other strategic aims:

"Too often, we have heard how allocations policies act as a barrier to new supply, with housing associations nervous about the extent to which local authorities will continue to nominate low income, unemployed households either from the waiting lists or through Choice Based Lettings, even when the association wants to do something different in pursuit of delivering mixed income, sustainable communities".

[CFE submission]

"Current [allocations] policy is a hindrance. There's considerable risk to HAs from the disconnect between affordable rent policy, welfare policy and LA nomination and allocation policies. Until these three factors can be re-connected…there's a disconnect between grant rates at less than 20% of costs and allocations policies requiring 100% of first lettings to go to LA nominations."

[CFE submission]

Rent controls

Housing Associations have to charge a social rent or an affordable rent on a given social rented or affordable rented home, depending on the basis on which the housing grant funding was awarded for it historically. This can create anomalies. For example, a housing association could, in practice, have three similar properties each housing similar families – both in terms of size and means – yet one family could be paying £120 a week social rent, the other £160 a week in affordable rent, and the other £200 a week at market rent. This is deeply unfair and needs to change.

"There is clearly a need for rationalisation of rents and a case for housing associations to be able to have their own rent policies. However, any increase in social rents would have implications for the housing benefit bill"

These rent controls also prevent housing associations having their own rent policies to pursue their wider charitable and strategic aims of reducing benefit dependency and supporting their tenants into work. In the case of homes let at an affordable rent of 80% of market rate, for example, this means that benefit dependency (versus social rent) is increased and the distance to the labour market can become insurmountable.

There is clearly a need for rationalisation of rents and a case for housing associations to be able to have their own rent policies. However, any increase in social rents would have implications for the housing benefit bill, given that over 60% of social housing tenants are on housing benefit. This can be controlled largely through the "limit rent", which caps the amount of housing benefit subsidy for social housing tenants, which is set on the basis of historical levels and varies by local authority. Detailed modelling, beyond the scope of this report, would have to be conducted to fully understand the housing benefit impacts.

PROPOSAL: TO CREATE A NEW CATEGORY OF HOUSING ASSOCIATIONS, INDEPENDENT OF HISTORICAL HOUSING GRANT.

Summary so far:

- The regulatory requirement for the *consent to dispose – which exists to protect public assets (historical grant) – and local authority nomination rights, are impeding housing associations' ability to strategically asset manage and to borrow in order to build new affordable homes;*
- local authorities with high, or even 100%, nomination rights to housing association stock have too little incentive to supply housing associations with land for new affordable housing; and
- social rent policy and rent controls, also attached to historical grant, are unfair and inflexible, and prevent housing associations being responsive to local markets and need.

During the course of researching this publication, Policy Exchange conducted a poll of chief executives and/or finance directors of 15 of the larger housing associations. Although this polling is not necessarily representative of the whole sector, the results suggest scope to improve the current regulatory arrangement that govern the relationship between historical grant, local authority nomination rights and rent policy for the existing social housing stock.

The polling results showed:

- two-thirds, or 67%, of the chief executives and/or finance directors believed historical housing grant should be written off;
- 70% of those believing grant should be written off (47% of all respondents) said their organisation would have some appetite in paying for it to be written off sooner rather than later, as long as it was at a discount with payments spread over 30 years;
- 67% said that local authority nominations of tenants were a problem for their organisation;
- the overwhelming majority favoured a new framework for agreeing local authority nominations, with 93% favouring regular negotiations with local authorities to decide these and 93% agreeing with a proposition of local authority land in exchange for local authority nomination rights ("land for nominations exchanges"); and
- 100% favoured greater rent flexibilities, where they could set their own rents within an overall renal income envelope contained by the limit rent with increases of CPI+1% a year, important to the containment of housing benefit expenditure.

These results point to a possible new deal for housing associations.

Box 2: Polling of chief executives and finance directors of large housing associations

		Yes (a)	No (b)	Don't know
Historical Grant:				
(1)	Should historical grant be 100% written off by the Government?	67%	33%	–
(2)	If yes to Q1, should this be done (a) immediately or (b) after 30 years?	40%	20%	40%
(3)	If grant was 100% written off after 30 years, would your organisation have any interest in paying for it to be written off sooner, but at a heavy discount and with payments spread over 30 years?	47%	53%	–
Rent Flexibilities:				
(4)	Would you favour being able to set your own rents and having your own rent policy, but contained within an overall envelope of CPI+1% increases across your organisation's affordable housing portfolio?	100%	–	–
Allocations Policy:				
(5)	Are local authority nomination rights a problem for your organisation?	67%	33%	–
(6)	Should local nominations be set through regular negotiation between each housing association concerned and the local authority?	93%	7%	–
(7)	Should nominations be attached to local authorities (LA) providing housing associations (HA) with land for affordable housing, perhaps as part of individual HA-LA negotiations, rather than being attached to (receipt of) government grant?	93%	–	7%

Many housing associations already innovate and want to build (or acquire) new affordable homes. These organisations should be freed from some of the regulatory requirements and other obligations that can impede their ability to do so. **In a radical shake-up of the housing association sector, this report proposes the creation of a new category of housing associations – independent of historical housing grant. All housing associations would be allowed to apply (opt) for this status, but not be compelled to.** Successful applicants would need to have demonstrated a strong and long track-record of new affordable housing delivery – namely the development or acquisition of new build affordable homes. The new grant-independent housing associations would be the exemplars and beacons of new housing delivery in the sector.

Grant-independent status would allow the housing associations to buy out their historical grant from the government at cost, probably at a discounted rate and over 30 years, in return for the removal of regulatory restrictions on disposals of affordable housing assets, nomination rights of local authorities, and a loosening of rent controls bound to that grant. The overarching principle behind grant-independent housing associations is freeing them up to use their balance sheets (and not new grant money) and asset management to increase the affordable housing stock and respond to local housing need. The current

arrangements entrench the dependence on new government grant money coming in order to grow the social housing stock in the future, rather than allowing this to happen through the balance sheet. The current arrangements belong in the 1970s and are no longer fit for purpose.

All the other regulations, such as those concerning tenant protections and those around financial reporting and conduct of housing associations to the regulator, would remain. So, existing social tenants would have exactly the same regulatory protections as before and through their social tenancy agreements – over 90% of which are life-time tenancies. Grant-independent housing associations would be able to make payments for the buy out over 30 years, so that any adverse effect on annual surplus positions is minimised.

In our poll of the chief executives and finance directors, 67% believed that historical grant should be written off; of those a further 70% (47% of all respondents) said their organisation would have an interest in paying for it to be written off sooner rather than later. The total historical grant (at cost) currently stands at £45.4bn.[31] The grant repayment could:

- be at a discount, say up to 50%, to improve take-up – much like Right to Buy; and
- be made over a period of up to 30 years to minimise impact on housing association cash-flows and surplus positions.

In order for housing associations to repay the government grant, they would either have to borrow the money or use the cash from their surplus positions. This would inevitably use some of their financial capacity. But this should be more than counteracted by the enhanced financial capacity through the additional freedoms to use their balance sheets and to strategically asset-manage. Otherwise it is unlikely that housing associations would opt to become independent, implying capacity across the sector would certainly increase.

In return for agreeing to the repayment of historical housing grant, probably at a discount, the housing association would be given grant-independent status and this would be conferred upon them immediately (i.e. not after 30 years when the grant is fully repaid). Accordingly, this status would exempt housing associations from a number of the economic regulations, nominations rights, and social rents attached to the historical grant. Specifically, grant-independent status would:

- allow the housing association to sell (dispose of) vacant social homes, or convert them into affordable or market rented properties, without the regulator's consent or the need to use the Recycled Capital Grant Facility (RCGF);
- absolve the housing association of most of its local authority nomination obligations;
- give the housing association the freedom to set its own rent policy, subject to the limit rent and limit rent increases.[32]

The first two steps would free up financial capacity both internally through additional borrowing capacity (for stock transfers) and strategic asset management, and externally by drawing in land from local authorities. It would enable housing

31 There has been much debate about changing the treatment of historical grant. In the accounting sense much of this debate has been overtaken by the advent of FRS102 – the international accounting standard being introduced in 2015 that will allow government grant to be treated as housing association equity.

32 The limit rent would still apply to rents but to the overall social rent income of a given housing association, not to the rents of its individual properties. The annual limit rent increases of CPI+1 % would also remain.

associations to build new social homes on a more than one-for-one replacement basis (for those sold) without government grant and unsustainable borrowing. Crucially, it would be a full departure from the outdated social grant model where social housing portfolios expand only through more capital grant provision from central government and additional housing association debt.

Ability to sell vacant social homes

Grant independent housing associations would be exempt from the economic regulation – specifically the disposal consent regime.[33] Section 172 of the Housing and Regeneration Act (2008) requires consent to be given to disposals of "social housing dwellings" by all private registered providers. Section 133 of the Housing Act 1988 prevents the disposal of social housing transferred from a local authority, constraining their valuations for borrowing purposes. Housing associations receiving any receipts from these sales would have to reinvest this for public/charitable benefit.

Table 1: Grant-independent housing associations – new freedoms and flexibilities in summary

Requirement	New "Grant-independent" Housing Associations	Existing "Grant-maintained" Housing Associations
Consent of the Regulator to dispose of social homes not transferred from a local authority?	NOT REQUIRED	REQUIRED
Consent of the Secretary of State to dispose of social homes transferred from a local authority	NOT REQUIRED	REQUIRED
Grant recycling	NOT APPLICABLE*	THROUGH THE RCGF**
Local authority (LA) nomination rights to existing homes and **not** transferred from the LA, where LA land **was not** provided	NONE	RETAINED
Local authority (LA) nomination rights to existing homes and **not** transferred from the LA, where LA land **was** provided	RETAINED for 25/30 years from point of land provision	RETAINED
Local Authority (LA) nomination rights to existing homes transferred from a local authority	RETAINED for 25/30 years from point of point of transfer	RETAINED
Local authority (LA) nomination rights to new homes	DECIDED BY LA LAND FOR NOMINATION EXCHANGES	RETAINED
New regulatory requirement on large housing associations to explain how their surpluses are being used	NOT APPLICABLE	APPLICABLE
Economic standards, including governance & financial viability, and value for money regulatory requirements	RETAINED	RETAINED
Consumer standards, including tenant involvement and engagement, and home quality	RETAINED	RETAINED

*Grant will already have been repaid to attain grant-independence **Recycled Capital Grant Facility

33 Disposing of Land (2014 version), Homes & Communities Agency www.homesandcommunities.co.uk/sites/default/files/our-work/dol_master_copy_140326.pdf

Independent housing associations would not be required to repay capital grant attached to the properties – or otherwise use the recycled capital grant facility. Namely, this historical grant will already have been repaid by these housing associations under the agreement with the government to become grant-independent.

Ending local authority nominations rights

Grant-independent housing associations would be absolved of most local authority nominations rights. These would be replaced with local "land for nominations" exchanges. In order for there to be an increase in affordable housing delivery from 45,000 homes a year to 60,000 homes a year, local authorities will need to contribute more land to housing associations for new affordable housing over and above what they are currently providing.

The local authority land for nominations exchanges would be agreed through regular negotiations (e.g. annual, or at spending review time). Central government guidance on pricing and best practice would be issued to support these negotiations, and this guidance would be prepared in consultation with housing associations, local authorities, and their representative groups. Such negotiations could be encouraged across all local authorities and housing associations (not just grant-independent ones), although local authority nomination rights would remain for the non grant-independent housing associations.

However, local authority nomination rights to existing housing stock transferred from a local authority would be retained for a time-limited period. They would also be retained where the local authority had provided the land for existing housing, again on a time-limited basis. The time-limited period, perhaps of 25 or 30 years, would apply from the point of transfer/land provision. The first stock transfers took place in 1990.

This should by no means be about punishing local authorities. Local authorities should be further supported and incentivised by central government in providing land to housing associations, perhaps using an enhanced New Homes Bonus mechanism. This could be even be funded from some of the receipts to central government from grant-independent housing associations paying back their historical grant. The use of incentives in this way would be in keeping with the localism agenda. This should be about the right incentives to local authorities to provide land for affordable housing. It should not be about imposing new affordable housing on local authorities top-down from Whitehall.

Independent rent polices

Grant-independent housing associations would be able to set their own rent policy – in essence there would be no need for social or affordable rents. Instead of having a number of different rents for similar properties inhabited by similar households, they could have their own single rent at the weighted average of these and one appropriate for the local area, if they so wished. Or, they could use cheaper rents to reward good tenant behaviour, including for tenants on the fringes of the labour market in order to improve their work incentives – reinforcing one of the traditional functions of housing associations.

Controls over rent levels and increases for those on Housing Benefit would remain in place through the "limit rent". This would be crucial to the containment

of Housing Benefit expenditure. However, instead of the limit rent applying to the rents of individual properties, it would instead apply to the envelope of a given housing association's overall rental income. There was unanimous support for this idea in our polling of the housing associations chief executives and finance directors.

Housing associations would not be compelled to become independent and this status will only be attractive for some. Crucially, those opting to become independent would only do so if it conferred additional financial capacity on them or other perceived advantages, even after taking into account the repayment of government grant. So this would benefit both partaking housing associations and the government, similar to the gains from trade concept in the economic literature. Gains from trade derive from efficiency gains – precisely what this proposal for independent housing associations sets out to achieve.

Box 3: Financial impact of grant-independent status

On housing associations

Grant-independent housing associations would, in all likelihood, need to borrow funds to buy out their historical grant from the government. Assuming 35% of housing associations opted to become grant-independent and an average price discount on the grant value of 50%, they would need to borrow around £8.4bn in total across a purchase period of 30 years, implying £280m a year ((£45.4bn x 0.35 x 0.50) / 30). In reality, however, surpluses would continue to accumulate over the 30 year repayment period, so adding to equity, and making the containment of debt gearing a realistic probability. It is unlikely that any housing association would agree to become independent unless that extra surplus they could extract from the greater strategic asset management and local authority land provision, as well as the ability to choose their own tenants, exceeded the value of their historical grant repayment.

On the public finances

The repayment of grant by grant-independent housing associations would raise a substantial amount of money for the Exchequer. There would also be on-going savings associated with reduced debt interest, if the proceeds were subsequently used to pay down the public debt.

Using the same assumptions set out above, including of a phased sale over a 30-year period, the in-year Exchequer savings would look something like the following. The on-going debt interest savings from paying down £8.4bn of public debt would eventually be around £275m a year.

Table 2: Annual savings for the Exchequer (AME*)

	2015–16	2016–17	2017–18	2018–19	2019–20	2024–25	2044–45
Total	£290m	£300m	£310m	£320m	£330m	£380m	£555m
Of which:							
Sale proceeds	£280m	£280m	£280m	£280m	£280m	£280m	£280m
Debt interest savings	£10m	£20m	£30m	£40m	£50m	£100m	£275m

*Excluding Housing Benefit Savings from increased affordable housing supply

2

Government Equity Investment in New Affordable Homes, Instead of Capital Grant

The way the government funds new affordable housing through capital grant is unsatisfactory to all parties concerned. For the government it remains expensive, at £1.1bn a year, at a time when the public finances remain tight. For housing associations it provides a lower level of grant that is unattractive: it incurs high and unsustainable levels of borrowing to plug the gap; the associated "affordable rents" can be a misnomer; and it imposes unacceptable financial risks on housing associations in the context of welfare reform – including direct payments and the benefits cap – which combined with (higher) affordable rents increases the risk of rent arrears. As a result affordable housing output could actually *fall* from 45,000 homes annually in the coming years. A grant model with only modest levels of grant is unworkable longer term. A new funding approach that recognises the fiscal constraints of the government needs to be found.

Cost to government

In the 2010 Spending Review, £4.5bn of capital grant funding was allocated for affordable housing covering the 4-year period 2011–15, around £1.1bn a year. In the last (2013) Spending Review, £3.3bn of capital grant funding was allocated for a 3-year period to 2018/19, again £1.1bn a year on average.[34] This was a dramatic reduction in the funding prior to 2010 of around £2.5bn a year. Nonetheless, the reliance on government grant for new affordable housing, at a cost to the Exchequer of around £1.1bn a year, is problematic at a time when the public finances remain tight. There is every chance too that current grant levels will not be sustained beyond 2018/19.

A zero grant model could therefore save the government a considerable sum of money, but only if an alternative funding form can be found to maintain current levels of affordable housing delivery. This alternative is important in the fiscal context because new affordable housing saves the government over £2bn in housing benefit expenditure annually, through cheaper (submarket) rents than the market rented sector.

Many housing associations building new affordable homes remain heavily reliant on government grant. This is for a number of reasons. The first is that grant fulfils basic subsidy function of bridging the "funding gap" associated with

34 www.gov.uk/government/news/35-billion-deal-to-build-homes-and-drive-local-growth

submarket rents. An affordable home might cost the same amount of money to build as an equivalent private market home, but submarket rents generate a smaller income return insufficient to cover the cost outlay without such subsidy to fill the gap. This subsidy needs to come from somewhere, although not necessarily from the government. Second, with the current funding approach, particularly the traditional social or affordable rent model forms, grant helps to support cash flows. Most obviously, 60% of the grant payment is made upfront, in cash, when building the affordable homes start on site. So this contributes to the cash requirement for the development and build out phase.

“The treatment of grant as equity in the funding equation is important in seeking a substitute for future grant money; namely it has to take the form of equity”

Third, grant is a form of equity that enables the housing associations to borrow. In other words, this equity is an *enabler* of borrowing; the more equity that exists, the more borrowing housing associations can undertake against it. To illustrate this, £1.1bn a year of capital grant money and an annual surplus of £1.9bn a year combine to give an additional £3.0bn of equity each year, on which up to £2.1bn of new borrowing capacity could be created on sustainable debt gearing of 70%. Without the grant money, only up to £1.3bn of new borrowing capacity could be created. This is especially important in the Affordable Rent Model, which relies on high levels of borrowing in order to maintain affordable housing output levels at the historical levels.

The treatment of grant as equity in the funding equation, which leverages in debt, is important in seeking a substitute for future grant money; namely it has to take the form of equity. It is not possible to replace £1.1bn of new grant money coming in each year with housing association borrowing, for example.

Unattractive to housing associations

The reduced grant offer with the affordable rent product, combined with the obligations for housing associations that come with grant funding, as described in the previous chapter, and associated high levels of debt, means that the deal on offer from the government is no longer attractive to many housing associations. This can be seen from the outturn of the recent grant bidding rounds of the Homes and Communities Agency and Greater London Authority. These had fewer bids from the larger housing associations in particular.

> *“Current grant levels and other funding terms are unappealing – it is clear from the greatly reduced level of interest in the most recent bidding round that the terms and risks inherent in a low grant/high rent approach to affordable housing are increasingly unattractive to providers. It is significant that this is the first time in over 30 years that housing associations have not submitted bids in excess of the amount of grant available.”*
>
> [CFE submission]

> *"The terms of the deal do not reflect the risk and reward equation – we want to develop new homes and we are willing to work with government as we have proved over many years but there needs to be a better understanding of the risks we are taking and a more sensible dialogue about how best to capture the capacity that undoubtedly exists in the sector."*
>
> [CFE submission]

> *"Housing associations and other developers are taking most of the risk in terms of cost and development yet there remains an expectation that we will let our new homes to households nominated by the local authority and that we will do so in perpetuity at rents dictated by government policy…"*
>
> [CFE submission]

Unsustainable borrowing

The current funding mechanism, the so-called *Affordable Rent Model, was introduced at the Spending Review* 2010[35] (see box). Since this time it has been the main funding model for new affordable housing in England.

Housing associations that build new homes face a number of genuine – and numerous – financial constraints preventing them from maximising their delivery of new affordable homes. First, the debt gearing constraints set out in their individual borrowing covenants (rightly) place a limit on the amount housing associations can borrow to invest in new affordable housing, typically at 60% to 80% of their equity.[36] This is an especial problem in the context of the new affordable rent model, which relies on high levels of borrowing to finance new affordable homes and this is eating up housing associations' debt capacity.

Some housing associations are already running at close to their gearing constraints, so that current levels of output of 45,000 affordable homes built a year may be unsustainable.

> *"The levels of debt that the programme implies, and the financing that debt requires (interest payments) cannot deliver the levels of development to meet the country's demand."*
>
> [CFE sub]

> *"Debt capacity is being burnt. Housing associations' ability to grow commercial income cannot keep pace."*
>
> [CFE sub]

> *"If we are to achieve the volume of supply needed it is difficult to see how this exact model can be replicated beyond 2018. The model eats up capacity quicker than a model with more grant."*
>
> [CFE sub]

> *"the model and the associated shift from capital to revenue funding … is also likely to have been a factor in the recent reduction in levels of affordable house building, since providers now need to secure more borrowing in order to deliver homes…"*
>
> [CFE sub]

35 For a thorough explanation of the Affordable Rent Model, see www.parliament.uk/briefing-papers/SN05933.pdf

36 Excluding revaluation reserves.

Box 4: What is the Affordable Rent Model?

In the 2010 Spending Review, the Affordable Rent Model, a new funding model, was introduced with Affordable Rents. Central government grant funding is no longer available for new house building (or acquisition) for social rents. The Affordable Rent Model is important because it grant-funds most of the affordable homes being built in England today. It remains a traditional capital grant and debt financing model, but represents a major shift in the balance of funding, away from capital grant and more towards debt financing, compared to the old social rent system. In other words, it moved away from a "bricks and mortar" subsidy (through capital grant) and further towards personal subsidy (through housing benefit).

To illustrate this shift, the average cost of social or affordable homes is around £150,000. The old social rent model utilised a more balanced mixture of grant and borrowing to fund social homes. Social homes were built for social rent with these rents typically 60% of market rents. The social rent model drew grant of around £60,000 per social rented home in today's terms, with around £90,000 drawn from a combination of borrowing and cross subsidy (– namely, surpluses, though with local authority council house building, cross subsidy was often in the form of land). Grant therefore typically funded 40% of the total cost of a housing scheme.

The affordable rent model stipulates that affordable rents should be charged on grant-funded affordable housing, at up to 80% of market rents. The model typically requires grant of around £30,000 per affordable rented home, with around £120,000 from a combination of borrowing and cross subsidy. Grant therefore funds around 20% of the total scheme cost in the current model.

In the Affordable Rent Model, new build or acquired affordable housing is overwhelmingly debt-funded. The new affordable rents around a third higher in gross terms, but 50% higher in net terms, because the cost-base is the same across both forms of rent. This extra net rental income allows housing associations to service proportionately higher levels of debt so that they can borrow more (subject to their debt gearing constraints). In the 2011–15 affordable homes programme, the average borrowing against rental income of a new build affordable rent home was just shy of £85,000.

Furthermore, an integral feature of the model is that the new affordable rents are charged both on the new build affordable homes *and* on some existing affordable homes, by converting social rented homes coming up for re-let into affordable rented ones. Conversions are a sizeable part of the funding in the Affordable Rent Model; on aggregate there is at least one conversion for every new affordable rent home built in the 2011–15 Affordable Homes Programme. The average additional borrowing from a conversion in that programme is around £20,000.

This means that, overall, total new borrowing for each additional new affordable rented home built (or acquired) is on average close to £105,000, around 70% of the funding for an affordable home. In debt gearing terms that is over 200%, well above the 60% to 80% sustainable levels cited.

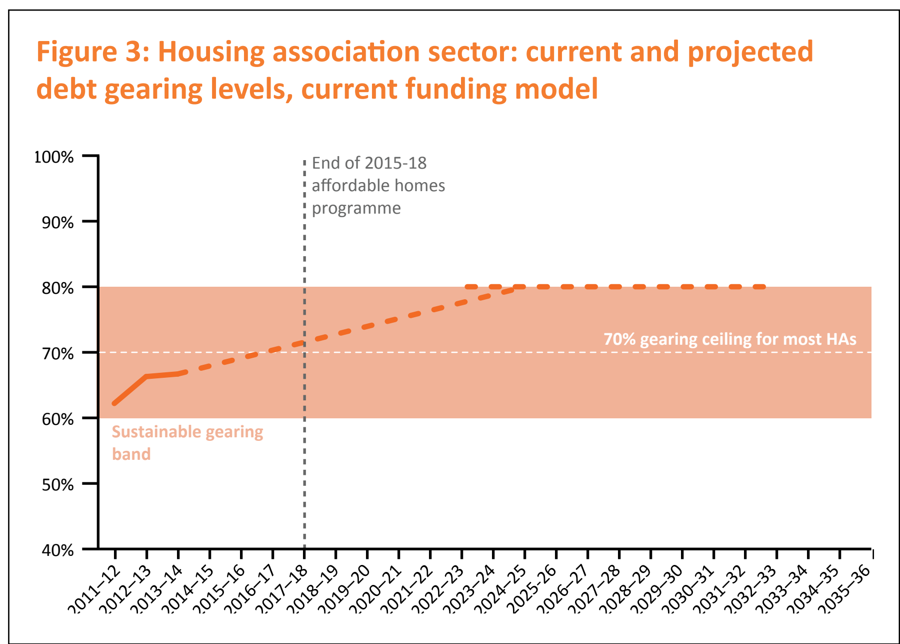
There are two major problems with high and growing levels of debt. These revolve around **sustainability** and **risk**.

Sustainability. The high levels of borrowing are causing aggregate debt levels – specifically debt gearing – to rise significantly and this is clearly unsustainable in the long run because of the debt ceilings in place. Borrowing across the sector currently stands at £52bn. Equity stands at around £60bn – of which historical government grant is £45.4bn and accumulated reserves £14.6bn.[37] Debt gearing currently stands at 86.8% accordingly (£52bn debt/£60bn equity). However, within this sector average the stock transfer housing associations have far higher gearing (205%) than the traditional housing associations (67%).[38]

Although the key debt metric – debt gearing – has been broadly constant across the sector over the last 5 years, this has been held down artificially by large surpluses generated as a result of the low interest rate environment (cost) and above inflation rent increases of RPI+0.5% plus convergence (income), which saw social rents increase by 6.1% last year alone. The sector average also masks sharply declining debt gearing in the stock transfer sub sector but, crucially, increasing debt gearing in the traditional sector from around 62% three years ago (and just after the advent of the affordable rent model) to 67% today. At that rate the debt gearing would reach 80% for traditional housing associations – the absolute maximum – within 10 years. This is also important because traditional housing associations currently deliver most of the new affordable housing in England.

"The sector is heavily exposed to future rises in interest rates, something that has been identified as a key risk by the Regulator"

Figure 3: Housing association sector: current and projected debt gearing levels, current funding model



Risk. A high level of indebtedness exposes housing associations to likely interest rate rises in coming years, which could also have a significant impact on cash flow and surplus positions and a knock on impact of reducing investment for new affordable housing. The sector is heavily exposed to future rises in interest

37 HCA 2013 Global Accounts of Housing Providers, p32.

38 HCA 2013 Global Accounts of Housing Providers, p30.

rates, something that has been identified as a key risk by the Regulator. The Homes and Communities Agency has recently estimated that a rise in the Bank of England base rate to pre-credit crunch levels of 5% could increase interest costs by £800m a year.[39] This is effectively equivalent to over 40% of the £1.9bn surplus reported in the latest year. This is despite the fact that two-thirds of housing association debt is fixed or long-term. The loss of £800m from cash surpluses could translate to as many as 10,000 fewer new affordable homes being built each year, when account is taken of the sustainable borrowing this could lever in. Accordingly, a one percentage point rise in interest rates could translate to as many as 2,000 fewer new affordable homes built a year.

Affordable rents, welfare reform and risk (arrears)

This is not to ignore the other key risks associated with welfare reform – future direct payments of housing benefit to tenants which, housing associations believe, will increase arrears rates by around 2 percentage points (from around 5% currently). Further risks highlighted in call for evidence submissions from housing associations arise from the fact that, for many, affordable rents are not affordable at all and this is another key issue in the context of welfare reform and (again) local authority nomination rights:

> *"Affordable Rents are not affordable to many of those nominated for affordable housing, which puts the residents under great strain."*
>
> [CFE sub]

> *"[The] Affordable Rent Model cannot be sustained if current policies on benefits are maintained, in particular the fixed benefit cap of £500 a week. The cap means that providers cannot raise rents with inflation without pushing tenants on full benefit into arrears. Not only does this pose major challenges for residents but it also threatens delivery as providers will be unable to demonstrate they can meet debt covenants through raising rents."*
>
> [CFE]

> *"The unknown impacts of the migration to Universal Credit and other threats to welfare benefits when combined with high rents, increases the risks of rent default very substantially."*
>
> [CFE sub]

> *"Local authorities are nominating tenants for affordable rent without proper regard to their affordability and capacity to sustain the tenancy."*
>
> [CFE sub]

> *"There is a need for greater freedom and flexibility for housing associations to ensure affordability at the point of letting – whether that is through higher subsidy that enables us to set lower rents to address social housing need or freedom to allocate to lower income working households to these intermediate rents to ensure sustainable tenancies".*

39 HCA 2013 Global Accounts of Housing Providers, p6.

These risks largely explain why housing associations are not spending all of their surpluses to invest in new affordable housing; they spent 82% in 2013,[40] with the remainder being put into reserves as the perceived risks rise. That means fewer affordable homes being built. Of course, some housing associations would be far harder hit than others by these risks and could see a far worse deterioration in their surplus position.

> "The problem with the Affordable Rent to Buy scheme for housing associations, however, is that the government loan sits on their books as debt"

For all of these reasons housing associations may struggle to build even the current 45,000 new affordable homes a year through the affordable rent model beyond 2018/19. The numbers may start to fall short from this time.

PROPOSAL: GOVERNMENT EQUITY INVESTMENT IN NEW AFFORDABLE HOMES, INSTEAD OF CAPITAL GRANT.

Summary so far:

- The £1.1bn a year on-going cost to the Exchequer of capital grant funding through the recent Spending Rounds are problematic during a time of fiscal constraint;
- the unsustainability of borrowing (i.e. increased gearing) – and the associated risks around high debt levels including rising interest rates – under the affordable rent model; and
- affordable rents are often not affordable and this, in conjunction with the direct payment of housing benefit and other welfare reforms, increases the financial risk (of arrears) faced by housing associations.

New capital grant money should be replaced with time-limited government equity investment, as the main way for the government to fund new affordable homes for submarket rent and shared ownership. There should be an aspiration to move to a more self-sufficient housing association sector over the next decade for funding the delivery of new affordable homes – no longer can a zero grant model remain off the policy agenda. The funding model needs to move away from high grant and debt-dependency. This does not mean zero government support. Rather, the underlying principle should be recoverable government equity investment and not capital grant funding. Grant is a non-repayable loan and it counts as government capital expenditure. Conversely, the acquisition of a (recoverable) government equity stake in the affordable housing asset could count as a financial transaction and so it would "score" as zero in public expenditure terms. The government's Help to Buy: equity loan scheme[41] is an example of a financial transaction that counts as zero public expenditure.

Housing associations would bid to the Homes and Communities Agency or Greater London Authority for the equity funding in exactly the same way as they would bid for capital grant – their bid would be on the basis of providing affordable homes for rent (or shared ownership). For example, a housing association might wish to develop or acquire a portfolio of 50 new build homes for submarket rent at 80% of local market rent, requiring total investment of £10m, of which it might seek £2m (20%) in equity funding from the government.

40 HCA 2013 Global Accounts of Housing Providers, p3.

41 www.gov.uk/government/uploads/system/uploads/attachment_data/file/221897/help_to_buy_mortgage_guarantee_scheme_outline.pdf

The new £400m time-limited Affordable Rent to Buy[42] product is an interesting policy development both because it is, in essence, a zero grant model which simply replaces grant with cheap repayable government loans treated as a financial transaction under the ONS classification. Under Affordable Rent to Buy, government provides loans to housing associations for up to 15 years, at minimal interest rates, for them to develop or acquire new build homes. In return for the cheap loans, the associations let the newly built homes at affordable rent for a period matching the loan maturity. Housing associations can choose when to repay the government loan, from year 7 to 15 (with a rising interest rate schedule to incentivise earlier sale). They can do so either by selling the homes at market value, or selling another home in their portfolio as part of their wider asset management strategy, or by using their cash reserves.

The problem with the Affordable Rent to Buy scheme for housing associations, however, is that the government loan sits on their books as debt. It therefore uses housing association's limited, and increasingly scarce, debt capacity. It cannot be a substitute for grant in the way that government equity can. The new model advocated here takes the affordable Rent to Buy approach as a basis, but replaces the government loans with government equity stakes. These central government equity investments could be recovered from year 7 to 15 years, as the government loans are under the Affordable Rent to Buy model currently, with repayment to the government following exactly the same means and principles.

However, the government equity investment could be in individual properties rather than an aggregate portfolio. A possible legal mechanism for the government equity investment in new affordable homes could be a form of trust for land and tenancy in common, where the housing association and government ownership shares for each home would be stipulated in the agreement. This would mean that the housing association would only be able to borrow against their ownership share and their secured debt would need to take a senior position, just as the mortgage does in the Help to Buy Scheme.

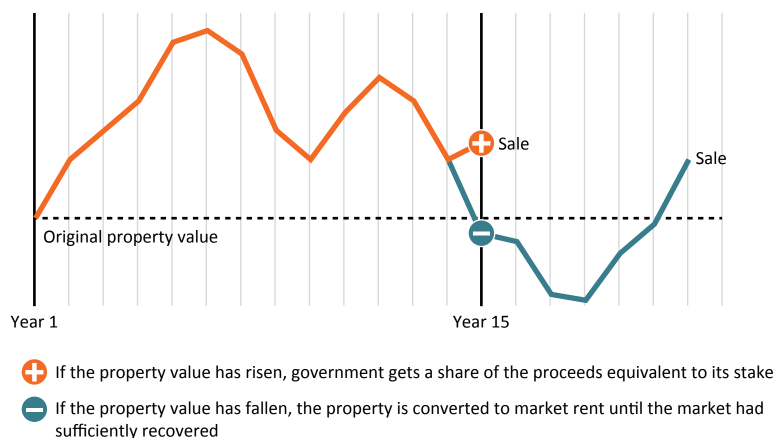
The government would be a non-income owner of its share in the new affordable housing held by the housing association. In other words, the government would allow its share of the property (e.g. 20% or 30%) to be rent free. This would facilitate a submarket rent level, while allowing the housing association to charge an equivalent market rent on its share (i.e. the corresponding 80% or 70%). The extent of equity held by the "operating" owner (i.e. the housing association) would set the proportion of rent to market rent for that dwelling.

Table 3: Trust for land and tenancy in common, ownership shares and rents charged

	Ownership share	Rent charged, as % market rent on the ownership share
Housing association	80%	100%
Government	20%	0%
Total	100%	80% (= affordable rent)

42 www.gov.uk/government/news/new-rent-to-buy-scheme-to-help-young-people-save-and-move-up-housing-ladder

Figure 4: Housing market risk mitigation: conversion of affordable homes to market rent



If the property value has risen, government gets a share of the proceeds equivalent to its stake

If the property value has fallen, the property is converted to market rent until the market had sufficiently recovered

In terms of rent policy, the model would aim to give maximum flexibility to housing associations and would be consistent with grant-independent housing associations having their own rent policies. So the ownership shares should be flexible: the housing association's percentage would reflect the type of rent product it wanted to offer. There would be no need for target rents or for a rent regime under this arrangement.

The government equity stake could also come with overage. This would mean that the government would make money on its investment in a rising market, but would share in the housing market risk (with housing associations) if the market fell.[43]

Box 5: Challenges to the government in providing equity investment

If government investment is made into a private body then it can be treated as a financial transaction (i.e. score as zero expenditure). However, there are related issues about what the government can invest in. There is some uncertainty about government's ability to invest in bricks and mortar assets, rather than buying a stake in an investment vehicle. The latter creates further issues around the responsibilities of being a joint owner of a business. This is why some believe that equity-linked loans might offer the best of both worlds by giving government an equity-linked return without the pains of ownership.

Housing market exposure is a big issue for the Department for Communities and Local Government (DCLG) investing in housing in particular – they have limited ability to absorb losses, limiting their room for manoeuvre in their risk-taking. This makes the certainty of fixed but limited losses (on cheap lending) more palatable than an equity stake that might incur bigger losses in adverse housing market conditions. But this, in turn, is unlikely to provide the best risk: return trade-off.

Another issue for the government is having an investment management function role – government deciding which investments to make and protecting them over their term. More risk-taking to achieve greater returns would require a stronger function to build DLCG's (HCA's or GLA's) capacity as an investment partner. This could be done

43 This would also follow the precedent of the help to buy: equity loan scheme.

through an investment vehicle rather than directly. The government has established a housing asset management function body within the Homes and Communities Agency and Greater London Authority has the London Housing Bank. This would allocate the equity funding on a bidding basis, much like the existing bidding processes for capital grant that typically follows each Spending Review. The body would manage the assets – including their eventual sale. It would assess bids for equity funding from individual housing associations at each bidding round on the basis of value for money – as it does with grant bids currently but, in addition, take account of the expected returns and housing market risk.

These are not likely to be fundamental obstacles for government equity investment.

The government would also have the right to be repaid its equity stake after 15 years, possibly through sale. This could be also be at a discount if the sale was to the tenant through the preserved Right to Buy. The housing association would have the right of first refusal to buy out the government's share (on the basis of a fair market valuation, possibly arbitrated by the Valuation Office Agency). In the unlikely event of a fall in the housing market over 15 years, where the sale of the property would mean that the housing association and the government would make a loss on their investments, the home could instead be converted to market rent until the time the market had recovered, if both parties agreed. The government would receive its share of the rental proceeds into a ring-fenced fund, in order to mitigate the capital losses.

Table 4: Housing association rental income generated to buy out the government's equity share

	Year1	Year2	Year3	Year4	Year5	Year10	Year15	
Cost	150,000							
Housing association capital (+4% HPI p.a.)	120,000	124,800	129,792	134,984	140,383	170,797	207,801	
Government capital (+4% HPI p.a.)	**30,000**	**31,200**	**32,448**	**33,746**	**35,096**	**42,699**	**51,950**	**£51,950 = repayment**
Gross rental income (+3% p.a.) (a)	6,300	6,489	6,684	6,884	7,091	8,220	9,529	
Gross Gvmt Rent	0	0	0	0	0	0	0	
Management & maintenance costs (+2% p.a.) (b)	1,515	1,545	1,576	1,608	1,640	1,811	1,999	
Housing association debt interest (£65,000@4%)(c)	2,600	2,600	2,600	2,600	2,600	2,600	2,600	
Net rental income (=a-b-c)	**2,185**	**2,344**	**2,507**	**2,676**	**2,851**	**3,810**	**4,930**	**£51,974 = cumulative net rent**

Modelling by Policy Exchange illustrates how under certain reasonable assumptions[44] a housing association could make sufficient rental surpluses over 15 years to buy the government out of its ownership share; i.e. it would have no need to sell the property or any other affordable home in its portfolio. Although this will not always be the case it does demonstrate that, at worst, only a small fraction of affordable homes would ever need to be sold to repay the government. The illustration is set out in Table 4.

The advantage to the housing association of government equity investment is that it makes the housing association's financial capacity go further. The housing association would only need to finance a proportion – here 80% – of the portfolio through a mixture of its own equity and debt, instead of 100% of it. This means that every £1 of a housing association's own financial capacity – through surplus and the possible debt attached to it – would finance 25% more affordable homes than without the government's equity stake. The government funding would therefore enhance the housing association's financial capacity x1.25.

Table 5: Enhancing housing association capacity with government equity investment

	100% HA financing requirement	80% HA financing requirement
HA Equity (from surplus)	£82,500	£66,000
HA Sustainable Debt (at up to 80% of HA equity)	£67,500	£54,000
Government Equity Investment (20%)	NIL	£30,000
Total	£150,000	£150,000

Local authority land is another form of equity that could be contributed and even be part of the trust for land and tenancy in common. The previous chapter outlined a new land for nominations rights exchange framework that would provide greater incentives and support for local authorities to contribute land to housing associations for affordable housing. By extension local authorities could acquire an ownership share in a new affordable home held by the housing association, in return for provided some of their own land into the mix.

Table 6: Enhancing housing association capacity with government Equity investment and land

	100% financing requirement	70% HA financing requirement
HA Equity (from surplus)	£82,500	£58,000
HA Sustainable Debt (at up to 80% of HA equity)	£67,500	£47,000
Government Equity Investment (20%)	NIL	£30,000
Local Authority Equity (Land) (10%)	NIL	£15,000
Total	£150,000	£150,000

44 Assumptions used: 80% housing association ownership share, 5.25% gross rental yield on that share, average management and maintenance costs in line with the traditional sector average (at 80% - the rest being deductible from the government's capital gain), debt interest of 4% (using debt guarantees), house price inflation 4% p.a., rental inflation 3% p.a. (CPI+1%), cost inflation 2% p.a. (CPI).

If housing associations were making a surplus of £3bn a year and using that entirely to build new affordable homes, it would be sufficient to provide the housing association equity (of £58,000 per home) for 50,000 affordable rent homes, or 40,000 affordable rent and 20,000 shared ownership homes.[45] However, it also implies government equity funding of £1.5bn a year (repaid after 15 years), which is above current grant funding of £1.1bn a year. Taking account of section 106 contributions might reduce this requirement to £1.3bn.

Box 6: What is financial capacity?

There are a number of measures of a housing association's financial capacity. The key one is the size of its surplus, which is income from rents, services (including service charges), and asset sales *less* their costs including maintenance, repairs, management and debt interest. The housing association sector recorded a surplus of £1.9bn in the latest year (2013). Loosely, the surplus is the main determinant of financial capacity to invest in housing – either in new build or acquisition, or improving the existing stock, or estate regeneration.

Debt gearing is another key metric – it is an indication of how much borrowing capacity remains on the basis of the current equity in the organisation. Loan covenants related to gearing are common in the loan agreements of traditional providers. It is calculated in a number of different ways. All calculations measure the proportion of debt to equity in a provider's financial structure. A common definition is to measures loans as a proportion of grant and reserves. Most loan agreements that use this definition set a maximum gearing level of between 60% and 80%. The traditional housing association subsector as whole has debt gearing of 66.7%.

Interest cover is a measure of a housing association's ability to service its existing debt, which depends on operating the surplus, the size of the debt and the level of interest rate on its borrowing. The Regulator measures interest cover ratio for the sector using the "EBITDA MRI" interest cover ratio, which is the one presented below.

Generally, additional borrowing is possible if debt gearing is below the limit set out in the lending covenants and if interest cover is sufficiently high – i.e. comfortably above 100% – particularly in the context of the current low interest rate environment, where interest rates are expected to rise.

Table 7: Key financial capacity metrics, housing association sector (2013)

	Surplus	Debt Gearing	Interest cover
All housing associations	£1.9bn	86.8%	138.0%
Traditional housing associations	£1.2bn	66.7%	147.3%
Stock transfer housing associations	£0.7bn	205.1%	118.3%

45 Loosely, a shared ownership home has only half the funding requirement of affordable rent home.

3

Government Encouragement, Support and Guidance for Housing Associationsto Build More Market Homes for Sale

Too few housing associations are building market housing for sale to cross subsidise the delivery of new affordable homes – only a handful last year. There is a culture of risk aversion at the regulator level – driven again by the legitimate need to protect public assets – and within some housing associations themselves. This is preventing many thousands of new affordable homes being built each year out of the profits. More housing associations therefore need to embrace market housing. There should be a greater recognition that provision of additional market housing will ease the pressure on social housing. A new balance has to be struck in the risk: reward equation of building market housing for sale. The government has to signal its support for this as part of an integral strategy of reducing the waiting lists. The regulator too needs urgently to fulfil its role in helping housing associations to better understand the risks of more market activity and in managing their risk exposures.

Why more market homes

Housing association delivery of market housing should be commended not frowned upon. This should also be viewed in the context of a deeply worrying – and apparently entrenched – declining trend in overall house building since 1980.

Building 300,000 homes a year for a prolonged period, whilst sustaining the current 1 in 6 homes that are affordable in the overall housing stock,[46] implies building 50,000 affordable homes a year (and 250,000 market homes). Given this 50,000 is close to the number of affordable homes already being built (see table), this suggests that housing associations could usefully use some of their financial capacity to increase the amount of market housing they are building, in order to contribute more to the 250,000 market homes a year needed.

46 DCLG Live table 209 House building: permanent dwellings completed, by tenure and country www.gov.uk/government/statistical-data-sets/live-tables-on-house-building

Figure 5: Overall housing completions in England[47]

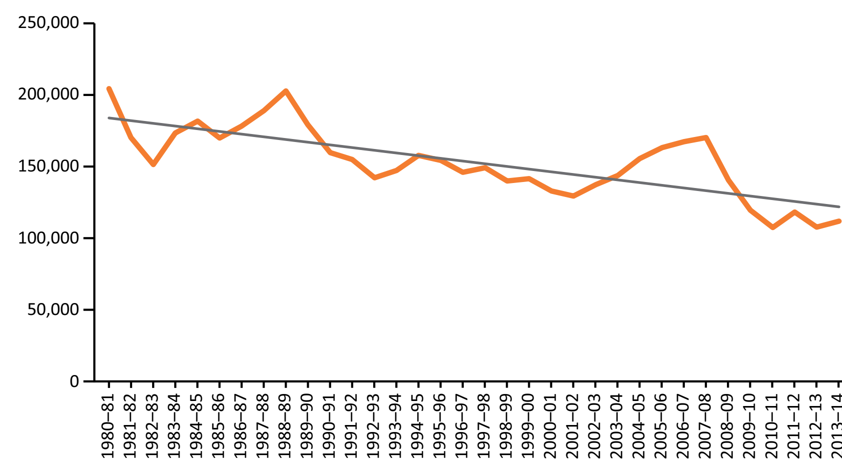


Table 8: Affordable housing completions In England, funded by the HCA and GLA[48]

	2009/10	2010/11	2011/12	2012/13	2013/14	5 year average
Total	53,172	55,909	51,731	36,733	36,352	46,779

Building more market homes would improve affordability and reduce the pressure on the social sector. Between 2000 and 2010 the waiting lists grew from 1.0m to 1.7m households.[49] This is not because affordable house building fell (it did not), it is because affordability in the wider market grew so much worse, in turn because market housing building was too low.

Housing associations have been encouraged by the government to develop more homes for open-market sale in recent years, i.e. replicating what private house builders do. Crucially, housing associations can use these profits to cross-subsidise affordable housing delivery. The profit margins on development for sale can be very high – in the region of 20%.[50] Selling a house at £150,000 could easily generate £30,000 of cross-subsidy to build or acquire a new build affordable home, similar to the average amount of government capital grant funding for an affordable home currently.

Too few housing associations building for market sale

Housing associations are already shifting increasingly to development for market sale to support (i.e. cross-subsidise) their core business of providing affordable homes. But this needs to be achieved on a far larger scale and across many more housing associations. Only a handful of housing associations are engaged in any meaningful activity currently. According to the 2012 Global Accounts of Housing Providers, 10 housing associations were responsible for building 97% of the sector's homes for market sale in that year.[51] A recent survey by Inside Housing showed that, of the 50 top housing associations by homes built, only 25 built any homes for market sale in 2013/14. The top 12 delivered 87% of these homes, so activity remains highly concentrated in a handful of housing

47 DCLG English Housing Survey 2012 to 2013. www.gov.uk/government/uploads/system/uploads/attachment_data/file/284648/English_Housing_Survey_Headline_Report_2012-13.pdf

48 DCLG Live table 1012 Affordable housing starts & completions funded by the Homes & Communities Agency and the Greater London Authority. www.gov.uk/government/statistical-data-sets/live-tables-on-affordable-housing-supply

49 DCLG Live Table 600 Rents, lettings and tenancies: numbers of households on local authorities' housing waiting lists1, by district2: England 1997–2013

50 HCA 2013 Global Accounts of Housing Providers, Part D1 – Financial Forecasts and sector risk, p34 (Figure 11, Operating margins by activity type). www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

51 HCA 2012 Global Accounts of Housing Providers, Annex D2 – Diversification of the Sector, p40 www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2012_full.pdf

associations. Increasing the number of housing associations building for market sale substantially is a critical part of delivering the higher market housing volumes needed.

All of the top 12 housing associations cited in the table are very large – those with a stock of 10,000 homes or more. It is true that, logistically, only larger housing associations will command the scale be able to build new homes for market sale. Within the sector, there are 71 housing associations with a housing stock of above 10,000 homes (and 339 with a stock above 1,000). The very large organisations can gear their organisational structures to do this, typically embodying subsidiaries (perhaps for-profit) for property development and market rental residential lettings.

Table 9: Top 12 housing associations, ranked by homes built for market sale[52]

Housing Association	Total homes built in 2013/14*	Affordable homes built in 2013/14	Homes for market sale built in 2013/14
One Housing Group	625	299	326
Genesis HG	751	338	259
A2Dominion Group	695	412	237
L&Q	916	688	189
Notting Hill HG	1,474	1,119	179
East Thames Group	500	346	154
Orbit Group	865	754	111
DCH (formerly Devon & Cornwall Housing)	535	432	103
Hyde Group	786	686	100
Affinity Sutton	825	733	92
Catalyst HG	429	345	84
Family Mosaic	509	448	61
Total	8,910	6,600	1,895

*Figures do not always sum, as other categories of housing are not shown

"Increasingly, [housing associations] are delivering their diverse activity through associated companies and other vehicles…[housing associations] completing the detailed statistical data return in 2012 reported they had over 350 subsidiary bodies.. Some providers are constrained in their activity by their charitable rules and therefore need alternative vehicles to deliver more commercial activity."[53]

Only £128m of the 1.9bn surplus reported by housing associations in 2013 came from building housing for market sale.[54] However, Housing Associations are already planning to increase their market housing programmes and are projecting a much bigger contribution to their surpluses over the next five years, to around £300m a year, from revenues or around £1.4bn a year (10% of Housing Association turnover), and more than double current levels.[55] The sector is forecasted to deliver 8,500 properties for outright sale across 2014 and 2015, generating a profit of £404m (or £47,500 per home, the high amount reflecting

52 Inside Housing - Ready For Take-off, June 2014. www.insidehousing.co.uk/home/analysis/ready-for-take-off/7004403.article

53 HCA 2012 Global Accounts of Housing Providers, Annex D2 – Diversification of the Sector, p41.

54 HCA 2013 Global Accounts of Housing Providers, p19.

55 HCA 2013 Global Accounts of Housing Providers - Financial Forecasts and sector risk, p39.

a London-centric focus). The numbers also imply Housing associations plan to build an average 7,500 homes for market sale a year between 2016 and 2018.[56] This illustrates the significant potential for commercial activity to raise money to cross-subsidise new affordable housing.

Table: Homes developed for market sale (£ million)[57]

	2014	2015	2016	2017	2018
Receipts from properties developed for sale	734	1,405	1,736	1,536	1,470
Surplus from properties developed for sale	141	263	356	322	336
Margin	19%	19%	20%	21%	23%

Despite the broad doubling of the sector's receipts after 2014 from homes built for market sale, to over £1.5bn a year, these receipts will still represent under 10% of the projected overall turnover of housing associations.[58]

Making a profit from building homes for market sale relies on a stable or rising market and is not without risk. Increasing the number of housing associations embarking down this route will inevitably increase the sector's exposure to housing market risk and potential market falls, notwithstanding the current market exposure through shared ownership products. A fall in house prices, combined with too much exposure, could tip a housing association into loss territory. The regulator of housing associations, the Homes and Communities Agency, pays close attention to this risk, given its remit for ensuring the proper financial conduct and the protection of social housing assets. It is inevitably situated in a more risk-averse position.

> *"Where diversification is not effectively [risk] managed, regardless of how well it is delivered, there is potential to put social housing assets at greater risk. Therefore, the Regulator will increasingly look for assurance that boards understand the extent of risk…"*[59]

Although the regulator is not actively discouraging housing associations from building for market sale, it clearly cannot be a driving force behind this agenda, as it can with cost efficiencies and value for money for example.[60] What the regulator can do, however, is help housing associations to understand the risks they are taking with building for market sale and to guide them in their risk management.

More broadly, there needs to be a better balance of market delivery and risk across the sector. For any given housing association going down this path, successful risk management is not about taking no or very low risk, it is about understanding the impact on the organisation if the risk materialises, and ensuring that impact can be successfully contained. No single housing association should have too much housing market exposure. From the regulator's perspective, a much better position would be for the risk to be spread across many housing associations – with containment of the individual exposures – rather than concentrated in relatively few as it is now.

56 Referring to the table: £1,736m + £1,536m + £1,470m = £4,742m; £4,742/3 (per year) = £1,580m; and £1,580m/£210,000 sale price per home = circa 7,500 homes.

57 2013 Global Accounts of Housing Providers, Part D1 – Financial Forecasts and sector risk, p39.

58 2013 Global Accounts of Housing Providers, Part D1 – Financial Forecasts and sector risk, p34 (Table13, Summary of income and expenditure account).

59 2012 Global Accounts of Housing Providers, Annex D2 – Diversification of the Sector, p41.

60 The HCA's Regulatory Framework, published in April 2012, included a new Value for Money (VfM) standard. This standard requires registered providers to articulate and deliver a comprehensive and strategic approach to achieving VfM in meeting their organisation's objectives. www.homesandcommunities.co.uk/sites/default/files/our-work/regfwk-2012.pdf, p14.

Currently only 12 of the very large housing associations are building a significant number of homes for market sale. They built just shy of 2,000 between them in 2013/14, of around 2,800 in total sector-wide. If all 71 of the very large housing associations in the sector could replicate this, then the very large housing associations would build nearly 12,000 between them (170 each) and, by extension to the rest of the sector, nearly 17,000 in total.

Furthermore, the delivery profile of house building by housing associations is back-loaded over the spending review period and so 2013/14 is a relatively low delivery year: around 25% below average. Taking this account should mean that on average 22,500 homes a year could be built for market sale sector-wide over the next few years, instead of just 7,500 implied by the financial projections , if many more housing associations played their part.

As well as making a significant contribution to market supply shortfall, the successful delivery of 22,500 homes for market sale instead of 7,500 projected – an extra 15,000 – would generate around £700m in profits to plough back into affordable homes on the current margins (15,000 x £47,500). By levering in £500m of debt (i.e. sustainable debt gearing of 70%), the extra pot of cross subsidy would be £1.2bn and enough for nearly 5,000 affordable rent homes a year in London (£1.2bn/£250,000). The implied turnover from building homes for market sale would be around £5.5bn a year, under 25% of total housing association turnover – i.e. not excessive so long as it is well risk-managed.

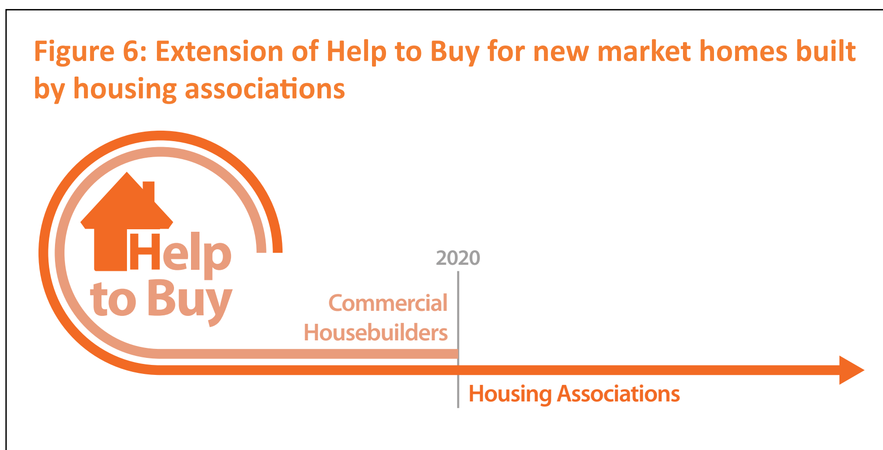
PROPOSALS: GOVERNMENT ENCOURAGEMENT, SUPPORT AND GUIDANCE FOR HOUSING ASSOCIATIONS TO BUILD MARKET HOUSING FOR SALE.

In addition to the creating new grant-independent housing associations to enhance their ability to borrow and strategically asset-manage, the government should support many more housing associations to build homes for market sale. It could do this in a number of simple ways.

Help to Buy

The Help to Buy scheme for new homes should be extended beyond 2020, but with eligibility restricted to housing associations on the basis that profits are being used to cross-subsidize affordable housing. This would also reposition the shared equity product as an affordable product, as it has been traditionally. Some housing associations are already tapping the Help to Buy scheme to develop properties for sale, so this seems a relatively straight-forward way for the government to provide financial support for housing associations to engage in more market activity, as well as signalling its support for this. The use of Help to Buy would also enable housing associations to share housing market risk with the government.

Figure 6: Extension of Help to Buy for new market homes built by housing associations



Valuing market sale homes

Incentivising development for market sale should also be reinforced in the bidding prospectus for capital grant (or government equity investment). This would recognise the value of additional market housing both in easing the pressure on social housing and improving wider affordability, as well as in contributing cross subsidy. Both of these would have consequential housing benefit savings which feature strongly in the government value for money calculations. Bids from housing associations that include the development for market sale should be treated more favourably. The criteria could even value market housing output as equivalent to, say, ¼ of an affordable home, or include market housing (not just affordable housing) in the calculations of "grant per home" – a key measure of government value for money used by officials.

New risk guidance

The capital grant (or government equity investment) bidding prospectus should be complemented by housing market exposure and risk guidance drawn up by the Homes and Communities Agency, to ensure housing associations understand the risks they are taking and help them to successfully manage these. This guidance could include recommended market exposure levels, which will vary from one housing association to the next according to certain financial characteristics, as well as possible risk mitigation strategies. Given the cyclical nature of the housing market, there may also be a case for the Homes and Communities Agency drawing on the regular advice of the Bank of England's Financial Policy Committee in macro-prudential management, so that the Bank would flag emerging risks with the regulator, who could adjust their guidance to (and requirements of) housing associations accordingly.

Strong risk management would be imperative to the delivery of market homes for sale at scale, not forgetting the lessons of the past:

> *"Although the sector is currently benefitting from an upturn in the housing market, the lessons from 2008 and 2009 should not be forgotten. A downturn in the housing market left some providers exposed with significant numbers of unsold shared ownership properties. Government intervention, through additional grant, was required to remedy the situation."*[61]

61 HCA 2013 Global Accounts of Housing Providers, p40 www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

4
Requiring and Supporting Inactive Housing Associations to Become Active

There are too many inactive housing associations that don't build or acquire any new affordable homes, including a significant number of large housing associations with a housing stock of 1,000 homes or more. Stock transfer housing associations also appear to build significantly fewer homes than traditional housing associations, and this appears as a result of very significant debt refinancing constraints. This could be preventing them from building an additional 7,000 homes a year. Housing associations should be supported to build these homes by overcoming these constraints. There should be an expectation of housing associations that surpluses are used to build or acquire new affordable homes.

Too many housing associations not building

In all, the housing association sector consists of around 1,500 housing associations owning or managing 2.7m homes. Although there are many exemplary housing associations that build or acquire new-build affordable housing, a large number of housing associations (described here as inactive) aren't developing or acquiring any new build homes at all – around 1,250 out of 1,500 of them, or 5 in 6, according to the regulator's 2014 Statistical Data Return (dataset).[62] It has also previously been reported that housing associations with a stock of 2,500 homes or fewer hold 20% of the sector's capacity to deliver but yet they build only 3% of affordable homes.[63] This has led to accusations of under-utilised capacity of these 'inactive' housing associations.

This is mostly because the sector has a large tail of very small providers who, even on aggregate, have extremely limited financial capacity. There are, for example, nearly 1,200 housing associations with fewer than 1,000 homes, and they own or manage only 5% of the sector's housing stock.[64] Many of these organisations are alms-houses.

There are 339 large housing associations – those with a stock of 1,000 homes or more. These organisations account for 95% of the stock[65] and so provide good coverage and proxy for the sector – and its financial capacity – as a whole. There are a number of interesting facts about these associations. The first is that a significant number of them – 86 – built no affordable homes in the latest year, according to the Statistical Data Return (dataset).[66] These accounted for 12.5% of

62 www.homesandcommunities.co.uk/sites/default/files/our-work/sdr_main_report_2014_full.pdf

63 For a fuller explanation and references see Hard Times, New Choices: A new deal for housing associations (2010), p10 www.lqgroup.org.uk/_assets/files/Hard-times-new-choices_1.pdf.

64 HCA 2013 Global Accounts of Housing Providers, p2. www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

65 Ibid

66 www.homesandcommunities.co.uk/sites/default/files/our-work/sdr_main_report_2014_full.pdf

the affordable housing stock and made combined surplus of £240m.[67] However, it is also true that not all active housing associations will build in every year and a few of the 86 cited here belong to group structures (with building programmes conducted by another part of the organisation).

The 2014 Statistical Data Return of housing associations also shows that housing associations had a shock of 2,666,053 homes in 2013/14, including 2,002,180 general needs homes. It also shows that 23,527 houses were built for social or affordable rent (either by or for housing associations) and a further 7,426 were acquired for low cost home ownership in 2013/14. This is 30,953 new build affordable homes in total.[68] This represents affordable housing growth – the addition of new affordable homes to the affordable housing stock – of +1.2%. However, because the delivery profile of affordable homes in the Affordable Homes Programme is back-loaded over the spending review period, 2013/14 is a relatively low delivery year. Looking at the 5 year average then affordable housing growth is closer to +1.8%. To get to the 60,000 affordable homes will require growth to be +2.3%.

Segmentation analysis of the Return shows no significant variation in affordable house building rates of the 339 largest housing associations according to their size. It shows similar building rates, as a percentage of the stock, of around +1.2% by the top 69 (10,000+ homes) and the top 339 (1,000+ homes) housing associations (see table). These drop significantly to +0.5% for housing associations with a stock of below 1,000 homes. However, the housing numbers concerned here are modest: if these smaller players had matched the +1.2% building rates they would have built 633 homes instead of 258 in 2013/14, a difference of only 375 homes. This suggests focus should be on the larger players who are inactive.

Table 10: New build affordable housing rates, by housing association size, 2013/14[69]

Housing association size	Affordable housing stock (% of total)	Affordable house building (% total)	New build: stock rate
Top 69 (10,000+ homes)	1,450,305 (55%)	16,730 (55%)	+1.2%
Top 339 (1,000+ homes)	2,613,275 (98%)	30,695 (99%)	+1.2%
The rest	52,778 (2%)	258 (1%)	+0.5%
All	2,666,053 (100%)	30,953 (100%)	+1.2%

Further segmentation analysis shows that stock transfer housing associations had lower building rates (+0.9%) than traditional housing associations (+1.4%). If stock transfer housing associations had matched traditional ones by building at +1.4% of their stock then, in this analysis, they would have built 16,200 affordable homes (1,158,851 x 1.4%) last year, instead of 10,900, or 5,300 more. Taking account of the fact that 2013/14 is a low delivery year, stock transfer housing associations would be building 7,000 more affordable homes in an average delivery year on this basis.

67 Ibid

68 An additional 5,943 affordable homes were purchased (acquired) by housing associations for rent.

69 Derived by Policy Exchange's analysis of the 2014 Statistical Data Return,

Table 10: New build affordable housing rates by housing association type, 2013/14[70]

Housing association type	Affordable housing stock (% of total)	Affordable house building (% total)	New build: stock rate
Stock transfers >1,000 homes	1,158,851 (44%)	10,878 (35%)	+0.9%
Traditional >1,000 homes	1,454,424 (56%)	19,817 (65%)	+1.4%
All >1,000 homes	2,613,275 (100%)	30,695 (100%)	+1.2%

*taken from the top 339 housing associations

So there are a number of key observations about inactive housing associations and those with lower building rates:

- they tend to be smaller housing associations (with a stock of fewer than 1,000 social homes);
- the larger ones (with a stock of 1,000 social homes or more) tend to be large scale voluntary transfers; and
- many of them make decent surpluses and so potentially the financial capacity to build or acquire new build affordable homes.

Financial blockages

There can be good reasons why housing associations are inactive. For smaller housing associations there are probably logistical issues and scale diseconomies that mean they cannot build in a cost-effective way. Even given the financial capacity, they are also likely to lack sufficient expertise to build. Larger inactive housing associations might genuinely not have a surplus to build with: a number of the more recent stock transfer housing associations fit into this category.

However, a major blockage is for mature stock transfer associations – those that are starting to make surpluses – who remain highly indebted. Stock transfer housing associations have average debt gearing of around 205% compared to the sector average of 87% and the traditional subsector average of 67%.[71] They often cannot access new borrowing to fund development or acquisition of new affordable homes, without agreeing to costly refinancing arrangements with their lenders. This is likely to be a major factor explaining the lower building rates of stock transfer housing associations.

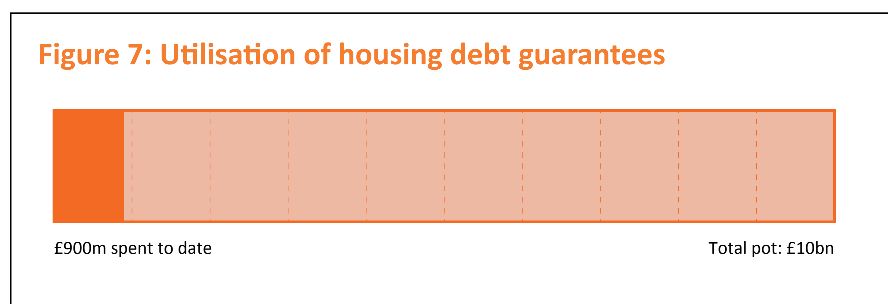
> *"Whilst the availability of debt finance is not currently a constraint for many housing associations, historic bank covenants can act as an artificial constraint…For example, many [stock transfer] housing associations have long-term bank debt at low margins held with banks that are looking to re-price existing loans. These associations can't negotiate new loan facilities without agreeing to re-pricing."*
>
> [CFE submission]

70 Ibid

71 Ibid

In recent years, including in the 2013 Spending Review, the government has placed much emphasis on financial innovation to fund affordable housing. Among the most important of these has been the Government-backed affordable housing debt guarantees (Affordable Housing Guarantees) introduced in the autumn of 2012. This mechanism aims to pass on the government's low borrowing costs to housing associations, in order to fund new-build affordable homes. Currently, these guarantees apply only to new borrowing. They also require fairly strict terms around asset cover of 115%, which is challenging for stock transfer housing associations on their current stock valuations. There is currently provision to guarantee the bond payments on up to £10bn of debt, with £3.5bn committed to affordable housing and £3.5bn to private rented housing, was well as £3bn held in reserve.[72] So far around £0.9bn of guaranteed debt for affordable housing has been issued, including £500m by the European Investment Bank in January 2014.[73,74]

Figure 7: Utilisation of housing debt guarantees



Currently, the guarantees enable housing associations to borrow in order for fund new affordable housing at a lower interest rate than otherwise – around 75 to 125 basis points lower. Most recently, Affordable Housing Finance (AHF), the Government's delivery partner for the scheme, priced a £198.5m tap of its government guaranteed bond at a spread over gilts – the cost of government borrowing – of 0.38% and an all-in cost of 3.30%. This was the lowest ever price for a long-term bond issue in the housing sector.[75] However, the permanency of debt guarantees remains uncertain – the current programme is due to close in March 2016 (debt already guaranteed will continue to be so, but no new guarantees will be available from this time). It would have to be extended beyond this date in order for the £3.5bn of affordable housing provision to be fully utilised.

> *"Affordable Housing Finance has successfully illustrated the advantage of using the government's balance sheet to issue to issue a AAA-rate bond…this has allowed housing associations to access bonds priced at 37 bps over gilts and an all-in cost of 3.76%"*
>
> [CFE submission]

> *"We …remain sceptical about the extent to which this will really increase output since the benefit is marginal and is nothing like the benefit provided by even modest levels of grant."*
>
> [CFE submission]

72 www.thfcorp.com/ahf.htm

73 www.socialhousing.co.uk/ahf-looks-ahead-to-more-bonds-in-the-coming-months/7003918.article

74 www.insidehousing.co.uk/finance/ahf-bond-tap-could-draw-in-overseas-wealth/7006640.article?utm_medium=email&utm_source=Ocean+Media+&utm_campaign=4955228_ih-daily-4.11.14et&dm_i=1HH2,2Y7H8,HBSQ64,AN45G,1

75 Ibid

> *"Any access to relatively cheaper funding is beneficial to the business model for delivering social homes because it reduces the gap in levels of available subsidy."*
>
> [FCE sub]

Extending the guarantees to existing debt (upon refinancing) would save housing associations around £75m to £125m a year if the full £10bn existing provision was utilised in this way. If all current housing association debt of £52bn was guaranteed it would save housing associations £400m to £650m a year. This would, however, be an enormous risk exposure for the government; they would ultimately be standing behind the payment of bond coupons on £52bn of debt (or around £2bn a year on an assumed 4% interest rate). Keeping within the current £10bn provision but utilising it in full would, therefore, seem more prudent. It would also cost the government nothing.

> *"Extending the use and scope of the current government guarantees programme would better allow housing associations to access competitively priced private finance and so enhance their capacity."*
>
> [CFE submission]

> *"Low cost government funding to enable housing associations to re-finance, thus relaxing the existing covenant restrictions would create considerable capacity."*
>
> [CFE sub]

Lack of incentives to build

There is nothing to compel housing associations to build or acquire new affordable homes, and it is likely some are not doing so when they could. One likely institutional issue is an "insider-outsider" problem, which is leading to the reinvestment of surpluses more for the benefit existing tenants than new tenants (namely those households waiting to form, including those on the waiting lists). It is important to recognise that there are a number of ways a housing association can use its surplus. First and most obviously, the surplus can be used to invest in building or acquiring new affordable homes. Second, it can be used to invest in improving the existing stock of affordable homes. Third, it can be used to improve the services and lives of existing tenants, including for those with special needs. Fourth, it can simply be put into reserves.

Unfortunately, the interests of those on the authority waiting lists and needing to be housed can be underrepresented in the key decision making functions – they are rarely found on the boards of the housing associations, for example. This is despite the fact that there is often an existing tenant on these boards. Furthermore, in some cases, the tenant satisfaction levels are more engrained in an organisation's performance metrics than building new homes.[76] This is despite the fact that 99% of affordable homes in the sector now meet the decent homes standard.[77] And so this insider-outside problem becomes almost analogous to that in the planning debate: the ever-present NIMBYs[78] (insiders) versus households waiting to form (outsiders) who are under-represented, often because they are from outside the local area. While it is a good thing that progress has been made

76 For some examples see Investing in Social Housing, The Housing Finance Corporation (2013) www.thfcorp.com/investing/investing-in-social-housing.pdf

77 HCA 2013 Global Accounts of Housing Providers, p7, table 1 www.homesandcommunities.co.uk/sites/default/files/our-work/global_accounts_2013_full.pdf

78 Not In My Back Yard

in recent years to improve the accountability of housing associations to their tenants, a better balance has to be struck between meeting the needs of existing tenants and building more homes for the millions of people struggling to find a place to live. The imperative has to be delivering new homes for new tenants.

Some housing associations may choose to not build or acquire new affordable homes, even though they have the financial capability (surpluses), and can readily observe the demand for them. A number of inactive housing associations appear content simply to operate as a landlord, providing good services to their existing tenants. However, in these cases the value in their balance sheets could be made available to use by others. L&Q's recent £10m offer to the G320 group of smaller housing associations, of match-funding for new affordable homes, is a good example of how this could happen through partnership working.[79]

Many housing association boards could benefit from other external representation on their boards, including public, local government or even commercial. Decisions taken by those boards need to reflect the interests of those who aspire to live in affordable homes as well as those of existing tenants. Ideally, there should be board representation for people needing to be housed, in response to the insider-outsider problem. However, it is important to recognise that these boards are independent and there are certainly logistical problems too that might prevent this from being practicable.

PROPOSAL: REQUIRING AND SUPPORTING INACTIVE HOUSING ASSOCIATIONS TO BECOME ACTIVE.

Debt guarantees

The Government should extend the government-backed affordable housing debt guarantees beyond March 2016, but for stock transfer housing associations only and for the specific purpose of refinancing their existing debt. This should be conditional on their delivery of new affordable homes – with bids considered on a case by case basis, as they are now. This could free up considerable capacity in the stock transfer sector to deliver new affordable homes and bring them closer to a par with traditional housing associations.

The prize of £75m to £125m a year in savings (which would add £ to £ to surpluses) from full utilisation of the £10bn guarantee is arguably modest. The real prize could actually come through making guarantees more attractive to stock transfer associations – and restricting guarantees to these organisations – enabling them to use it to refinance existing debt and unlocking their latent capacity. The total debt of stock transfer housing associations stood at £18.5bn (of the £52bn sector wide) in 2013/14, so the current provision (including reserves) could cover a sizeable proportion of that.

> *"An affordable mechanism to refinance, such as the guarantee programme, would give [stock transfer] associations the capacity to take on new debt that is otherwise locked to develop new homes."*
>
> [CFE submission]

79 See also www.g320.org/wp-content/uploads/2014/07/140514-JRF-housing-associations-development-full.pdf

> *"We have talked to a wide range of [stock transfers] who have indicated that using guarantees to refinance existing debt and restructure balance sheets would enable them to deliver additional new homes."*
>
> [CFE submission]

> *"One [stock transfer] ...indicated they would be very interested in using guarantees for refinancing confirming they would definitely take on more debt and develop if they could lower the cost of their historical debt. The anticipated cost on the guaranteed debt would make it worthwhile even set against significant breakage fees...they would have a net increase of capacity [which] would support delivery of an additional 566 homes."*

A new requirement to use surpluses to build

In response to the insider-outsider problem, a new regulatory requirement should be created for large non grant-independent housing associations to report on the way they are using their surpluses. There should be a rebalancing of interest at the housing association board level to take fuller account of the interests of the millions of people stuck on the local authority waiting lists needing to be housed. The reporting should include the options that boards have explored and considered to develop or acquire new affordable homes, including through partnerships with other organisations. This should also help to uncover any specific blockages that are being faced by these housing associations in the delivery of new affordable homes.

> *"Despite the regulator's recent enthusiasm for value for money there is no obligation on housing association boards to utilise their capacity to build new homes... We believe that there should at the very least be an expectation that boards of all housing associations should be obliged regularly to report on how they are using their financial capacity to help support the development of new homes... Too often they do not, which cannot be compatible with their charitable objectives."*
>
> [CFE submission]

Appendix A
Roundtable Discussion: A Summary

As part of the research process for this report, we held a roundtable framed around the following questions:

- Can the affordable rent model continue to deliver current levels of affordable housing output indefinitely? What are the pinch points/areas of concern?
- Is equity financing within an evolved affordable rent model an attractive and viable proposition? Why isn't there more equity financing now and what are the blockages?
- Could the use of the affordable housing guarantee on existing debt enable housing associations to deliver substantially more affordable homes? Could this be preferable to more grant?
- Why aren't housing associations building more marketed rented homes? Is there enough mix on new development and how else can we encourage housing associations to deliver more mix?
- How much of a hindrance is the current allocations policy guidance for housing associations? How much of a difference would greater freedoms on allocations (and rent levels) make?

The roundtable was held under the Chatham House rule, but a brief summary of each area is depicted below.

Can the affordable rent model deliver current levels of new affordable housing indefinitely?

- 20 years ago housing associations were all about social rent. Now it's a mixed bag exemplified by reduced appetite for grant.
- Outright sale is now an important component of cross subsidy.
- The aim is that 10 years ahead housing associations should be self-sufficient and more in control of their own destiny.
- The affordable rent model was rushed, untested and implemented rapidly. It's also a misnomer as it is not affordable to many clients.
- Housing associations' core purpose is to house poor people, the question is where does the support come from without grant?
- There needs to be certainty. The GLA produced a London based programme – the key message being a need for well-defined parameters to deliver consistency and stability.

- It is incredibly hard to conceive a single model for affordable rent that will satisfy all providers.
- A bold step would be to break the connection of homelessness into affordable housing, a change in allocations policy.
- In reducing grant we need to consider what levers and incentives are in place to ensure affordable housing output is maintained.
- Affordable rent doesn't work everywhere. Only in high income boroughs. Affordable rent is a new marginal tenure.
- The existence of the debt guarantee is insufficient in this world of structural deficit.
- There are 4 pillars to why investors like affordable housing/housing associations (1) regulation (2) grant (3) secured [mortgage] finance and management (4) direct payment of housing benefit by local authorities – under threat.
- Affordable rents are definitely not sustainable "Indefinitely" for a number of reasons that it doesn't stack up with rent levels.
- The role of surplus is important – we need housing associations nudge to use balance sheets.
- 10–15% grant means development without grant is on agenda. But although this allows more freedom local authorities are reluctant.

Is equity financing of affordable housing an attractive and viable proposition?

- Gearing vs cashflow issues. Equity can alleviate gearing but cash flow is actually a bigger constraint than gearing – equity joint ventures can and are used. Equity is not the magic bullet.
- Equity can be considered as a substitution for grant [so long as the substitute isn't debt]
- Land is another key form of "equity": releasing land for housing but holding an interest on the income stream = patient money/investment.
- Barriers to entry for small players are raised because they face the same regulatory burden as a large organisation. One size fits all regulation, which is current statute, doesn't work.
- Another point about equity could be using grant in different ways. Government risk sharing – "overage".
- On asset management there are some difficult politics about surrendering [Local Authority A] property and building somewhere like [Local Authority B].
- There have been occasional flashes of interest of officials in looking at historical grant. There would be concern at attempts to convert it into an equity distribution.
- Although grant is a regulatory hook, could other means be used?
- Grant has been important as a control – the presence of strings attached to grant, refusing consent of disposal, prevented Cosmopolitan from being even worse.

- Grant is 40 years old. When do we say the state has had its money's worth? i.e. write it off? Fundamentally it is a "Non-repayable loan". It is cash spending by state not on balance sheet.
- The treatment of grant on balance sheet is changing with FRS102 – grant will no longer be a "deduction".

Could using the affordable housing guarantee on existing debt deliver more homes?

- Narrow remit of "additionality"? The State Aid exemption is based on production of Affordable Housing. But it could possibly still hold on basis that it fulfills charitable status (but risky). So it may attract a fee and undermine the benefit.
- Extending guarantees is not a solution to affordable housing provision. Subsidised housing needs subsidy – whatever that is and whoever provides it.
- The bottom line is that the guarantee is still debt so it cannot substitute for grant substitute. Cheaper debt costs is one factor but structure another. A more realistic target could be to extend the existing guarantees window beyond 2016.
- New entrants. Can we use guarantees to help, establish/support them? New entrants face barriers to entry. Incumbency problems; a large number of housing associations (700 with 0.5 million homes) just aren't doing much, perhaps new entrants are needed?
- For many housing associations the question is why should we build more homes? The regulator can do little about this.
- There's already lots of hidden capacity of housing associations and cultural indolence. There is scope for efficiencies. On cost benchmarking, why not benchmark against the market instead of other housing associations?
- New entrants could be needed for large scale developments if no one else is prepared to partake – i.e. garden cities and urban extensions.

Why aren't housing associations building more market rented homes?

- Market rent. There is appetite and lots of activity in London and investors are buying market rent.
- But there is lots of effort and competition for sites and housing associations are outbid in the market for land supply, as they compete with build for sale.
- Early modelling [by housing associations] shows market rent might not always work. Some housing associations are creating deferred sale market rent products.
- Market rent needs a commercial return, it is not a social or charitable activity.
- There is a wall of investor money but not for development finance.
- There is a role for housing associations in providing market rent but it is still a niche activity: with only 2% of housing associations partaking in private rented sector provision – 3 of the major housing associations.

- The level of appetite for investment in housing associations is good; they have the advantage because of the regulatory wrapper – it provides investors with confidence.
- Housing associations are natural providers of private rented sector homes as they are not dividend-focused.

How much of a hindrance is the current allocations policy guidance?

- Local authorities are not taking a wider view of pressures in local housing markets.
- Strategic housing market assessments follow the market as it is now, rather than the market we need.
- There is the overall housing market that needs to be looked at, not just looking at housing waiting lists as the premise.
- Allocations policies are difficult to change politically – there needs to be progression and non-market households need to get housing!
- Welfare reform and a lack of housing supply and the new powers of LAs to discharge their homeless duty have all come at once tripping each other up; so the market has developed in the way it has with rents increasing across London.
- [Local Authority] has 3x the homeless acceptances than average, but private rented sector homes are not always available for them.
- In their assessments of tenant suitability, providers interrogate tenant information more than ever before.
- Consideration of mix. Urban extensions, for example, need a mixed lettings policy to create diverse communities.

Appendix B
Call for Evidence: A Summary

As part of the research process for this report, we released a call for evidence aimed predominantly at housing associations which received around 10 responses including through our online form. The questions are detailed below.

Survey questions

Partaking Housing Associations may wish to answer in the context of their own organisation.

Please describe, qualify and/or quantify in your responses, wherever possible. Supplementary documents or supporting evidence pieces are also welcome.

1. How much longer do you believe the "Affordable Rent Model" can sustain current levels of new affordable housing delivery, assuming a continuation of current grant levels?
2. What other financial innovations could be/have been adopted in order to deliver affordable homes?
3. Should the restriction on the affordable housing debt guarantee being used only for new development be removed (e.g. to allow refinancing of existing debt) and could that substantially raise the delivery of affordable homes?
4. Is equity financing an attractive and viable proposition, including for Housing Associations?
5. Should Housing Associations be much bigger players in the provision and management of market rented homes? If yes, how could this be achieved?
6. How much of a hindrance is the current allocations policy guidance for Housing Associations? What changes would assist housing associations in managing their stock and improving tenants lives?
7. What restrictions are there on housing association assets which could be adapted to maximise value (e.g. amending S133 restrictions on LSVT stock to allow MV-ST valuations)?
8. What impact would changing the treatment of historical grant (e.g. conversion and equity) have on housing associations' ability to develop?

£10.00
ISBN: 978-1-907689-87-1

Policy Exchange
Clutha House
10 Storey's Gate
London SW1P 3AY

www.policyexchange.org.uk