“Where next?” Housing after 2015

Creating a sustainable housing investment model

'Where next?' is the third in the joint PricewaterhouseCoopers and L&Q 'Hard Times' series of publications.

The series is designed to explore how housing associations can best respond to the new age of austerity in public expenditure as government housing policy evolves.

This third report looks beyond the immediate context of the Affordable Rent investment model. It assumes the Government's target of 170,000 new affordable homes will be met with housing associations contributing around 150,000 homes towards the total, and looks at the role housing associations can play in creating and funding a new, sustainable rented housing market offer to deliver the housing England needs for the longer-term.

It calls for new thinking from housing associations, local authorities, the private sector and government to build a mix of funding and products that achieves a cross-tenure, mixed income offer, including involving the market rented sector and institutional investors more systematically in the provision of below-market rent housing.

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We would also like to acknowledge and thank the numerous senior figures from parliament and the housing world – in representative bodies, local authorities, government bodies and housing associations - who commented on various drafts. Their input was extremely valuable in finalising our thoughts.

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Introduction

Over the next four years, housing associations and other providers will deliver up to 170,000 new affordable homes. But what happens next? What shape will subsequent national affordable housing programmes need to take? How can England's housing markets respond to economic and demographic change and provide the very significant numbers of new homes required?

The focus of this report is on how to deliver a continuing strong pipeline of new affordable housing development from 2015 onwards. Our aim is to contribute to longer-term strategic thinking about how to create a more consistent, sustainable and adequate level of new housing provision in this country.

We focus particularly on the role housing associations can play, using all their inherent flexibility to operate in different parts of the market. But our proposals are also designed to create a space which all potential providers can inhabit, so they too can play their full part in the partnerships that will undoubtedly be essential. The aim must be to use the considerable resources and expertise available across the public, private and voluntary housing sectors.

Capital grant remains a crucial part of the funding equation for affordable housing. An expanded capital programme would help increase supply. It could – perhaps should - have a larger role once again in the future. But we acknowledge that it is unlikely to grow significantly any time soon and we concentrate on ideas to make revenue subsidies work to best advantage. We also examine how new sources of funding can be drawn into the mix, how efficiency can be improved and existing assets better used.

The boundaries between social rent, intermediate rent products and market rent have already begun to blur. Our proposal, at the strategic level, is to create a more plural rented sector where the 'joins' are more seamless. People needing rented housing would have greater choices - through better supply of homes, better quality of homes and reasonable security - whichever part of the rental market they were housed in, and would have more opportunity and flexibility to move up the housing ladder.

Under our proposals, housing associations could choose to take on the risks and opportunities created by any new financial flexibilities government offers to deliver more below-market housing, working in close partnerships with local authorities, or they could choose to maintain their current form and role.

And private companies and institutional investors would, for the first time, be able to invest in a market rented sector (MRS) which offered acceptable yields and delivered better prospects of steady income streams and asset value growth.

The report is not intended as a blueprint, but an attempt to offer potential solutions to what is a complex and multi-faceted policy issue. Different providers will have, and make, different choices. The key is sufficient flexibility in the system to encourage providers to increase the volume and mix of housing produced. That, in turn, can help to deliver more consumer choice.

We are conscious that we have left some big issues unanswered. Part of the detailed debate to be had on our proposals includes finding agreed ways through such thorny issues as the best way to maintain below-market rent affordability, the need to revise tenancy agreements, the treatment of historic grant, and more. This paper aims to kick-start a debate. It is not intended as the final word. It is a first contribution in the hunt for new solutions.

Executive summary

- There is a growing demand for market rented sector (MRS) homes from poor and vulnerable households and those on middle incomes. With access to both social rented housing and the mortgage market likely to stay rationed for years to come, demand and competition for limited MRS stock can only increase. With the MRS set to have a bigger role in more people's lives, often for many years, it needs to become more accessible, accountable and flexible to meet their needs effectively. Housing associations can play an important part in making this happen. (p.7)

- The Affordable Rent investment model implicitly recognises the nature of the housing crisis now affecting poor and vulnerable people and those on middle incomes, but despite some positive innovations it looks unlikely to offer a sustainable basis for delivering sufficient affordable housing growth to meet a rising level of need over the longer-term. (p.9)

- Affordable Rent will absorb large amounts of the housing association sector's financial capacity. Illustrative L&Q modelling shows that, even with substantial new business efficiencies allowed for, associations would need to borrow around £15 billion by 2015 to build 150,000 homes and meet stock investment and refinancing commitments. The sector's capacity to continue developing would diminish swiftly. To maintain production beyond 2015, a sustainable pipeline needs to be established now, involving new funding arrangements. (p.10)

- While capital grant subsidies remain low, a sustainable and affordable rented housing market will inevitably require a larger MRS input, as well as production of more new homes in the traditional affordable housing sector. Sustainable provision will require a greater plurality of providers, products, partnerships and funding. To deliver the necessary size, quality, affordability and level of security people need to stay comfortably in the MRS, sometimes for many years, new sources of finance and a different form of rented housing are needed. Adapting the new flexible tenancy so it is able to straddle the subsidised and open rental markets could, alongside availability of discounted public sector land and the provision of some form of tax incentives, offer a solution to attracting institutional investors into the rented housing sector at scale. (p.11)

- Local authority partnerships should also form a key part of the solution going forward. HRA reforms should place LAs in a considerably better position to lead housing development partnerships from 2012. PricewaterhouseCoopers estimate that nationally, over the next 30 years, the potential value of new local authority investment capacity could be as much as £54 billion. How much of this money will ultimately be available for investment in existing and new stock will depend on local decisions and approaches to rent increases, debt management and cost control. (p.14)

- Housing associations could use their unique values and advantages as flexible voluntary sector providers to create the kind of differential market offer investors and consumers need, with any profits helping to cross-subsidise further below-market housing investment. They could act as key delivery vehicles and portfolio managers to upstream investors in market rent products; guarantors of quality and a degree of tenancy security; safeguard government investment where people are housed in the MRS using subsidy; and continue to offer a pathway to home ownership for those who want it. (p.13)

- Government could maximise housing associations' role in this new world by allowing the sector new operational freedoms and flexibilities. L&Q modelling shows that managing rents and existing assets differently could release further latent capacity in excess of £20 billion for investment into new below-market housing approaches, depending on the number of housing associations wishing to change the way they work. (p.16)

- Capturing the value of these new freedoms and flexibilities in a new 'social equity fund', possibly with mutual status, could protect released public investment by offering a clearly accountable guarantee over its future use for public benefit. The fund could be held as a contractual liability on the housing association's balance sheet and fully applied to the purpose of supporting new development and regeneration activity for people needing homes at below market price. As the fund was gradually used, so the liability would reduce. (p.19)

- Housing associations will always maintain their social mission. Those housing associations choosing a more highly geared and higher risk future would continue to hold large amounts of social rented housing and to be social businesses with clear social goals. But they would also need to develop new funding, legal and governance models and be prepared to show real market leadership and innovation, in close collaboration with local authority partners, in order to deliver new capacity into the market. Those preferring a lower risk future could continue to support provision for social rent, using the capital subsidies available. (p.17)

- The regulatory environment would need to be designed to have appeal beyond current affordable housing providers, helping to open the door to new private sector investment and involvement. All registered providers choosing to develop under this new model, whether public or private, would be offered public land opportunities and some form of tax incentives in return for an agreed level of provision for people unable to afford the open market, guaranteed tenancy standards and a higher degree of security for those tenants who want it. They would adopt a recognised governance code and be required to provide some assurance over their financial standing. But regulation should be no more onerous than is necessary to achieve the stated goals. (p.19)

- If the volume of new affordable homes is to grow and be able to meet the needs of people who cannot afford the open rental or sale markets, government will need to accept a level of cost to the public purse. In essence, affordable housing is a simple model: providing housing at below market levels will always require subsidy, irrespective of whether the final product is held and managed in the public, voluntary or private sector. (p.17)

A dual housing crisis

Persistent shortages of new housing supply are now combining with reducing public expenditure and restricted mortgage credit to leave large parts of the population unable to meet their housing needs in an affordable or satisfactory way.

This housing crisis spans two distinct groups. The 1.75 million households on England's housing waiting lists include many poor and vulnerable people, but also many with no prospect of being eligible for social rented housing: low to middle income households, generally with at least one person in work.

In years past, many more of the poorest would have been able to meet their needs in the social rented sector, while many more of those on higher incomes would have found their way into home ownership.

Aspiration for home ownership remains high. Recent research from the Halifax shows that 77% of 20-45 year old non-home owners still aspire to own their own home. But the reality is that most do not expect to fulfil that ambition any time soon. Many more people now believe they will need to rent homes for years to come – a phenomenon the Halifax has labelled 'Generation Rent'[1].

With government capital grants for new social housing unlikely to increase for the foreseeable future and mortgage credit restrictions expected to ease only very slowly, access to both the social rented sector and the open market for sale will continue to be constrained.

Large numbers of vulnerable people and lower to middle income working families are now therefore competing for homes in the market rented sector (MRS) and that competition is only likely to become more fierce. It is a battle better paid households are best placed to win, as more landlords seek income certainty in the face of welfare benefit reforms.

Without a new approach it is hard to see how the market rented sector will make the step-change in size, quality or security that is required to provide the longer-term housing to suit family needs in a changed marketplace.

Increased demand is likely to make the market rented sector less affordable. In many places market rents are already high. Assured Shorthold tenancies provide little security of tenure and the quality of MRS housing is variable, with limited standards and regulatory controls[2].

A swathe of reports over the last year from bodies including the Building and Social Housing Foundation, the Halifax bank, the Smith Institute and the Resolution Foundation have all anticipated further MRS growth, with some suggestions that the sector could house close to a quarter of all English households within a decade[3].

But quick, haphazard growth does not necessarily bring the kind of housing people really want or need, and there are serious question marks over whether the MRS will be able to manage further significant expansion successfully without major change.

To date it has been very difficult to entice large institutional investors into the market to provide development scale and more systematic practices. Government efforts to attract large investors have made some progress (the Olympic Village includes a substantial MRS element), but the pace is slow and there remain clear barriers to investor engagement.

1 Halifax press release, 31/5/11 – 'Generation Rent'
2 Based mainly on limited legislation and the Government's Housing Health and Safety Rating Standard.
3 'Tenure trends in the UK housing system', BSHF, June 2010; 'Meeting the housing needs of low-to-middle earners', Resolution Foundation, March 2011; 'Generation Rent', Halifax press release 31/5/11; 'The end of the affair', The Smith Institute, June 2011.

Without a new approach, the growth of the MRS will be mainly in the hands of small scale individual landlords, who have restricted scope to increase their portfolios on any significant scale. Portfolio growth is likely to lag demand and it is hard to see how the sector will make the step-change required to provide the longer-term housing to suit family needs in a changed marketplace.

The danger is that many more households will find themselves living in unsatisfactory conditions (whether overcrowded, struggling to pay rents higher than they can afford, sharing lower quality accommodation, living with friends or living with parents) at an age when they should have a reasonable expectation of a home for themselves. This will impact on their ability to improve their circumstances and fulfil their aspirations, with knock-on impacts for social and economic mobility.

With the MRS set to play a much greater part in more people's lives, often for many years, it needs to become more accessible, accountable and flexible to meet their needs effectively. Housing associations can play an important role in making this happen.

Can Affordable Rent provide the answer?

The Government's new housing investment framework implicitly acknowledges the reality of a dual housing crisis. It allows local authorities, with their partners, to determine the kind of subsidised housing provision required in their markets and provide homes both for low social rents and for Affordable Rents at up to 80% of private rented levels - though the emphasis in new housing is strongly on Affordable Rent homes.

Alongside more flexibility in the management of housing waiting lists, transfers, tenancy length, the housing of homeless people and use of low cost home ownership schemes, in theory the new investment model offers a route to provide homes for both the most vulnerable in society and people working at low to middle-income levels.

Affordable Rent, when combined with the current development pipeline and other important commitments, will absorb large amounts of the housing association sector's capacity within the next four years.

The housing sector has committed to producing up to 170,000 new affordable homes by 2015 through a combination of this new system and the existing pipeline. While local authorities and private house builders will make some direct contribution, and a large and important indirect one, the onus on developing and funding the large majority of these homes is on housing associations.

The new housing investment model gives associations some important new flexibilities. Greater freedom to manage assets, together with higher rents for new homes and a proportion of vacant homes, will increase revenues and enable housing associations to provide more housing choice for customers, better efficiency, and improved business management.

But it also presents some complex financial and practical challenges. In particular, the change in emphasis from capital to revenue subsidy will make the new system far more 'debt rich' for associations. To fully subscribe the new National Affordable Housing Programme, housing associations are using a mix of higher borrowing, efficiency savings and reliance on cross-subsidies from sales.

Financial impacts

It is difficult to be definitive at this stage about the scale of the additional borrowing associations will need. A range of factors will affect loan requirements. The mix between cross-subsidy, efficiency savings, conversion of voids to Affordable Rent, contributions from local authority partners including land and s.106 contributions, capital subsidy and borrowing is likely to remain fluid as the programme develops over the next four years. It will also vary from location to location, depending on the attitudes and demands of local authorities. The impact of the Government's welfare reforms on revenues is another uncertainty at present.

Housing associations will be approaching this programme with a view to adapting as they go, depending on circumstances, with the Homes and Communities Agency needing to monitor and administer the programme using the same flexible mindset. The quality and depth of housing association understanding of local markets and strong collaboration between housing associations and individual local authorities may go some way to keeping the debt burden down.

What is clear, however, is that many housing associations will be taking on considerably more borrowing and risk by 2015. Affordable Rent, when combined with the current development pipeline and other important commitments, will absorb large amounts of the sector's capacity within the next four years.

L&Q has modelled a number of illustrative scenarios examining what the financial profile of the housing association sector might look like by 2015, assuming that it produces around 150,000 new affordable homes, and building on the base of information available in the Tenant Services Authority's 2010 Global Accounts.

About 82,000 affordable homes are currently in the development pipeline, requiring residual funding of around £6 billion. The remainder of the 150,000 homes (including the mortgage rescue and empty homes programmes) will need to be fully financed in a range of ways during the programme.

If 80% of the new programme were to be built as Affordable Rent and housing associations also converted 50% of general needs relets to Affordable Rent, the sector would need to take on a further £8 billion in loans by 2015.

The time to define what a sustainable housing future looks like is now. It is important that government, local authorities and housing providers all understand well in advance how the next substantial programme of new affordable housing will be delivered.

Over the next four years housing associations will also need to borrow around £4 billion to invest in improvements to existing stock and £6 billion to refinance existing debt on new terms.

On this basis, in total housing associations could need to borrow £24 billion gross, or £18 billion in net new finance by 2015. Cash interest cover would fall to 100% at peak debt and the overall sector gearing ratio (defined as the level of third party debt compared to the level of reserves and government grant held) would hit 95%. This would leave housing associations in a challenging financial position and make it very difficult for the sector to manage a further large affordable housing programme under the same rules.

Adapting the model to reflect cash flows from general asset management, 10% efficiency savings in management and maintenance costs and a freeze in business inflation costs for two years, the borrowing requirement drops to around £15 billion. Cash interest cover would be 138% and gearing would be 85%. The risk profile of the sector grows very significantly, but association cash flows remain strong enough to service the debts.

However, making even relatively small changes to the key financial variables has a substantial impact on the viability of the model. For example, a 1% increase in interest rates, a 2% increase in inflation and a 1% increase in rent arrears would weaken the gearing ratio by 5% and the interest cover ratio by 20%.

A double dip in the housing market could also quickly increase borrowing requirements.

While the appetite for affordable housing debt in the capital markets is good, £24 billion would equate to somewhere in the region of 30% of all UK bond issuance over an average four years. With local authorities looking to refinance a level of Housing Revenue Account debt during the period too, there are obviously limits to what the bond market will be prepared to accept. £24 billion would be difficult to finance; £15 billion would probably be as much as the markets could stand. On that basis, substantial efficiency savings and cost controls will be essential if developing housing associations are to manage the overall financial equation to 2015.

Housing association boards have a duty to maintain sound and sustainable businesses that are financially robust and ensure existing tenants continue to receive good services into the future. Given the higher levels of risk that will be attached to new development, any prudent housing association must seek to maintain sufficient financial headroom and capacity to be able to deal with a more uncertain operating environment.

The risk of overtrading is clearly present and will be firmly in the minds of both boards and the social housing regulator. The sector has an excellent track record of organisational strength, which the regulator and every single association has a strong interest in preserving. But there is an obvious social imperative to maintain the flow of new affordable housing in a situation where so many people are in need.

If today's investment model is unlikely to be a genuine long-term solution, all public and private organisations with an interest in housing should now start seeking to define what a sustainable housing future looks like and establish a development pipeline on that basis. It is important that government, local authorities and housing providers all understand well in advance how the next substantial programme of new affordable housing will be delivered or there is a real risk of a major and damaging hiatus in development.

Housing associations need to reach 2015 in a strong and healthy financial condition to be able to contribute effectively to any new solution.

Establishing a sustainable rented housing market

The core thinking behind Affordable Rent - finding innovative ways to finance the volume of new homes needed and trying to construct a new type of rented tenure - makes sense. The key elements that can solve England's dual housing crisis are new sources of finance and a new form of rented housing. The issue is finding a system which achieves this sustainably.

Establishing a sustainable rented housing market at sufficient scale requires a rethink of the incentives available for all necessary providers to get involved, be they public, voluntary sector or private developers.

People need a range of options to suit their circumstances at different times of life.

The rental market must play its part in achieving the vital goal of providing enough housing supply to enable all those who need it to access a home they can afford – whether social, intermediate, or full market – with pathways to ownership in time for those who want them.

The boundaries between the affordable housing sector and the market rented sector are beginning to blur. There are already many families housed in the MRS using housing benefit to subsidise their rents, while Affordable Rent starts to move affordable sector rents more in the direction of the market.

In an era when government grants are likely to be severely restricted, providing sufficient new housing will probably mean further blurring of those boundaries. Sustainable provision is going to require greater plurality of providers, products, partnerships and funding mechanisms.

The ability to flex rents in the affordable sector will become even more vital to help sustain new financial capacity and meet the needs of different communities. But there is real scope, too, for the MRS to support a much more mixed income clientele, effectively operating 'cross-tenure' and bridging the size, quality and security gap.

A new form of rented housing, adapting the new flexible tenancy to be suitable for the MRS, and offering guaranteed quality standards and enough security of tenure to create settled communities, could go a long way to properly meeting people's needs, irrespective of income. This new form would straddle the social, intermediate and private markets and be open to everyone.

At the same time, establishing a sustainable form of rented housing at sufficient scale requires a rethink of the incentives available for providers if they are to get involved, be they public, voluntary sector or private developers. The financial answer is not straightforward.

Housing the lowest paid and vulnerable people will continue to require capital grant, and more capital funding would help increase affordable housing supply. But while grant remains restricted, a range of other financial inputs will be needed across the affordable rented market spectrum, from the use of public land to continuing s.106 contributions, direct investments from local authority partners using their new financial powers and other sources of income, and cross-subsidies from sales.

Beyond this, while government is unable to provide the level of funding needed to improve housing supply directly, it will be necessary to attract new sources of finance in the shape of more direct private institutional investment. This will almost certainly require the use of discounted public land and some form of tax incentive. Without the right yield, institutions will not invest.

In return for public funding and other contributions, such as deferring receipts on land, government and local authorities could expect to receive a share of long-term capital growth and agreement that a proportion of homes provided should be for people needing below-market rents. Mixed tenure and mixed income communities should be the norm, and offering public land at below market price or with delayed return should come with the proviso that development will deliver mixed communities, creating a range of products for a wide range of people, and helping to avoid State Aid issues. The Government's planned mapping and release of public land to build up to 100,000 homes by 2015, and encouragement of local authorities to do the same, could play a very important role here.

The key issue is how this can then all best be pulled together into a new framework to deliver the rented homes that are needed.

> *A new form of rented housing which offered longer tenancy options of, say, between five and ten years, could give the cash flow certainty investors will look for and allow time for asset value growth.*

Attracting institutional investment

As things stand, commercial and institutional investors holding cash have real choices about where to place their money, particularly in the current economic climate, and those choices will always be dictated by risk and return. Up to now, private rented housing has not offered the rates of return these organisations require. The private rented market in the UK is dominated by small scale individual landlords with limited ability to expand.

While the risks of investing in many other sectors have grown through the economic downturn, the comparative safety of investing in housing is offset by its traditionally poor yields. Commercial property still offers higher yields than residential rents. The differential in London at the end of 2010 was less than 1%, but in some other parts of the country the yield gap is almost 3%[4]. As a result the appetite to fund new private rented housing on any large scale basis has been limited. This will continue until institutional investors can get a return on residential property comparable to any other commercial investment.

The Homes and Communities Agency has worked to encourage institutional investors into private rented housing in recent years, but, despite a small number of valuable and high profile deals, progress has been slow. In the 2011 Budget the Government took its own first steps towards encouraging more investment in private renting with changes to the treatment of Stamp Duty Land Tax on bulk purchases.

The outcome of the Government's consultation on the entry barriers for residential Real Estate Investment Trusts could be crucial. Structuring REITs so they can invest in residential property more easily and deliver a tax advantage to investors could help create better yields and, alongside the offer of public land equity, pull more companies into the sector.

To change their stance, institutional investors will want some certainty of cash flow and the prospect of a good yield over a decent length of time. They will also look for scale and a level of asset value growth. This will require, among other things, reasonably stable market conditions, more professional management and maintenance of properties, and a belief amongst consumers that the market rented sector offers good quality, reputable housing.

4 L&Q Research

A new form of rented housing which offered longer tenancy options of, say, between five and ten years could give the cash flow certainty investors will look for and allow time for asset value growth. Some kind of accredited 'kite-marking' scheme to guarantee a recognised standard of management and maintenance could then satisfy the quality requirements of investors and consumers. These conditions would form the quid pro quo for any Government financial support.

The smaller Buy-to-Let investor could choose to opt in or out of additional support with its concomitant obligations and continue to provide homes on terms much as now, using assured shortholds. Some tenants' circumstances may well allow them to be less concerned about levels of tenure security or a particular quality standard.

There are ways of using the housing association sector's values and unique advantages as flexible, non-state providers to create the kind of differential offer investors and consumers need.

But delivery at scale should aim to create a new tier of professional private renting, to offer more choice, flexibility and security to people on a range of incomes.

How can housing associations contribute?

Housing associations are in the ideal position to play a leading role in developing a broader housing offer within the market rent sector. There are ways of using the housing association sector's values and unique advantages as flexible, non-state providers to create the kind of differential offer investors and consumers need.

Housing associations could:

- use their financial capacity to invest in new housing in partnership with others, including becoming key delivery vehicles for upstream institutional funders of market rent and acting as portfolio managers, helping to achieve the required scale
- act as guarantors of quality and a degree of security to the benefit of both investors and consumers
- act as credible, trustworthy landlords for those needing revenue subsidy to keep their rent below market levels, safeguarding government investment
- help to change perceptions of the market rented sector and ensure people feel more comfortable with staying in MRS homes for as long as they need to
- continue to offer a pathway to ownership for those who want it, using their long experience of supporting people into low cost home ownership.

Over the coming years, housing associations will, in any case, have to become much more flexible in terms of their market offer to successfully operate a rent regime which is more closely linked to market rent levels. This experience will be an excellent grounding for more long-term engagement with the market rented sector.

Associations and other providers could adapt the new flexible tenancy form to create a cross-market offer delivering the longer tenancies and notice periods investors and some consumers want. All housing association providers operating market rent schemes could be required to seek accreditation and manage homes with the assurance of the quality kite-mark. Any profits associations make could help to cross-subsidise further affordable housing investment.

Local authority investment

From 2012 local authorities should also be in a considerably better position to lead new housing development in their areas, as strategic enablers and/or direct providers.

Reform of the Housing Revenue Account in 2012, the additional financial freedoms under the Localism Bill, the value of their public land banks and other new levers should all give local authorities the financial clout to make a real difference in their markets, leading partnerships of the willing to produce new social rented homes, the new form of rented housing, and pathways to owner occupation through low cost home ownership options.

A 2011 report from PricewaterhouseCoopers and the Smith Institute estimates that nationally, over the next 30 years, the potential value of new local authority investment capacity could be as much as £54 billion. How much of this money becomes available for investment in existing and new stock will depend on local decisions and approaches to rent increases, debt management and cost control.

The release of more public land for housing development through the Government's new land initiatives should support local authority-led efforts to deliver more new homes for both rental and sale in all parts of the market. Strong collaboration and partnership working between councils, housing associations and other providers would also improve development viability and options.

Overall, the freedoms provided by HRA reform and the asset base that will be under councils' control mean that, in the medium to long-term, local authority-led partnerships are likely to contribute significantly towards the supply of new affordable housing.

Maximising the role of housing associations

Housing associations are social businesses with a social mission. They will continue to own large amounts of social rented housing, much of it subject to nomination arrangements with their partner local authorities. This will not change however associations develop their businesses in future, and the vast majority would wish to maintain a strong role in helping to house the poorest and most vulnerable people in society.

But in a changing housing market, and as a different financial relationship with government develops, housing associations will need to adapt if they are to retain their importance and relevance. Housing associations have a strong reason to get involved in the new form of rented housing, as part of a balanced range of housing products and services they can provide, and they have the ability to create a differential offer of real value to the market.

To maximise their role, housing associations need the capability and opportunity to operate in a different way from today. Those that choose to move into this area have to become much more commercially astute, boosting their financial capacity as far as is reasonably sustainable to provide significant volumes of new housing across the rental market spectrum, while maintaining a primary focus on those unable to afford full market prices.

Keeping rents affordable

The new Affordable Rent model, with rents at 80% of market rates, will have very different effects on tenants' disposable incomes in different local housing markets. Higher rents also need to be evaluated in the context of the planned overall ceiling for weekly benefit payments, which is likely to have an impact on larger families with low incomes particularly.

New financial capacity should not be created at the expense of making rents unaffordable for housing associations' key customer groups in some markets. Associations need to continue to give people the opportunity to use affordable housing as a springboard to improve their life chances.

A number of housing associations have been testing ways to ensure rents stay affordable under the new model, yet deliver a level of additional financial capacity that continues to allow developing associations to produce new homes in reasonable volumes.

Recent work by the University of Cambridge for Affinity Sutton suggests that a blanket 80% of market level could prove to be a blunt instrument in many markets, with much depending on how the market rent level is established. Affinity Sutton found, for example, that the going market rate for properties in its own stock could be very different to that suggested by Local Reference Rents for equivalent sized homes[5].

L&Q has researched its own resident base to assess a reasonable affordability measure for the majority of residents. It found that, using a target of 35% of net income, an effective balance between generating new financial capacity and maintaining affordability for residents is achievable[6].

This is inevitably a complex equation, with a host of competing factors needing to be weighed in the balance. But, effectively, this broad approach to rent setting represents a safeguard, capping the rent level that can charged in any local market to ensure affordability.

5 'Bridging the Gap', Affinity Sutton, August 2011

6 L&Q defines net income as income net of tax but including applicable benefits (tax credits, child and council tax benefit). Affordability is based on the rent contribution made by tenants (after any applicable housing benefit) as a proportion of net disposable income.

In a lower value area reviewing affordability on the basis of 35% of net income might result in an adjusted rent equivalent to 80% of market rent, but in a higher value market it would represent a much lower percentage. Overall, the modelling suggests that by defining affordability this way rents might rise from the existing national average of roughly 45% of market rates to around 55%.

The Cambridge study for Affinity Sutton also used 35% of net rent to net income as a reasonable affordability measure, and the Resolution Foundation has shown that low to middle earning households currently spend around 40% of net income on housing, fuel, transport and food[7].

It is not too long ago that there was a general, unwritten consensus in this country that an 'affordable' rent might cost around 30-35% or so of a household's net income. Moving back to this kind of measure would achieve the Government's goal of creating new financial capacity from rents while keeping rent levels affordable and avoiding adversely affecting work incentives.

Household income as the key determinant of below-market rent levels is a logic recognised and used by many other countries. It is also a prime consideration in the choice of home for people who can afford to buy or rent in the open market.

More flexibility to manage rents and assets

Further rent and asset management freedoms could boost capacity significantly, while maintaining reasonable affordability for consumers. L&Q's indicative modelling suggests that, taking account of regional market variations:

- convergence of all social rents over 10 years at an average affordability level of 35% of net income (equivalent to a national average of 55% of market rent) could produce extra borrowing capacity of £20 billion nationwide
- converting 50% of housing association social homes that become vacant to market rent over four years from 2015 to help pump-prime new MRS supply would generate an extra £5 billion
- shared ownership could be offered to the 15-20% of existing social rented tenants who research shows could afford it. If only 1% of them took up the offer, this would produce around £2 billion
- writing off grant on staircasing receipts from shared ownership homes would generate another £4 billion.

Clearly, there are limits to how any individual property can be used and the reality is that some form of mix and match approach across these possible options would be necessary. And while the primary purpose of these new flexibilities would be to create new public benefit, any potential State Aid implications would need to be carefully considered. But there is real potential to generate a very substantial fund offering a level of financial space some way into the future.

The obvious question mark with this approach is around its impact on the housing benefit bill. However, providing the flexibilities to increase supply of homes at below market rents should enable some people currently receiving substantial subsidy in the MRS to lower their housing costs and subsidy needs. The suggested convergence level would also see affordable rents averaging 55% of market rates rather than the 80% the Government's Affordable Rent model targets. Increasing levels of construction would have the important gain, too, of reducing benefit payments through job creation.

The sector will need to work with government to monitor the impact on housing benefit over time and ensure public expenditure is reasonably controlled and additional disincentives to work do not occur.

7 'Squeezed Britain: The 2010 audit of low-to-middle earners', Resolution Foundation, Nov 2010

In essence, affordable housing is a simple model: providing housing at below market levels will always require subsidy, irrespective of whether the home is delivered by the public, voluntary or private sector. Subsidy can be capital or revenue based, or a combination of the two. It can be reduced by providers taking measured risks and driving efficiency, but a greater supply of below-market housing will require public expenditure.

Housing associations can become more efficient in managing assets to improve yields, reduce future borrowing requirements and generate more capacity.

A stronger focus on asset performance

There is also scope for housing associations to become more efficient in managing assets to improve yields, reduce future borrowing requirements and generate more capacity.

Amongst larger private residential companies it is not uncommon for portfolios to be reviewed annually and for stock to be rationalised, with around 5% of the stock sold off to increase efficiencies, reduce long-term costs and make way for investment in new homes. Private companies also tend to be strong on keeping the difference between gross and net yields down across their stock by targeting investment where it adds greatest value and focusing on what tenants are prepared to pay for.

In a tougher financial world, housing associations may need to copy some of these techniques. In 2010/11 just 15% of L&Q's stock accounted for 75% of maintenance spend, for example, and gross rental yields ranged from over 7% to under 1%.

There may be a case, too, for either selling or converting to market rent a proportion of high value stock in strong markets, and for further rationalisation of stock outside of main operating areas. However, rationalisations of housing association stock need to avoid creating adverse social impacts. It is vital for many low paid families that associations maintain homes in expensive city centres.

At a lesser scale, associations could do more to reduce under-occupancy of stock to ensure more people in need received suitable accommodation, for example by increasing incentives for people to downsize and free up larger homes, tackling unauthorised sub-letting or encouraging people to let rooms legitimately.

Careful consideration and use of all of these measures could help to improve efficiency and generate additional capacity for investment in more new homes.

A choice of futures for HAs

The value which could be extracted for new investment through these mechanisms will inevitably vary from place to place and from housing association to housing association. Different associations will also choose to focus their efforts in different ways. Not all will want to offer new forms of market provision, even at below-market rents.

Some housing associations will choose to continue much as they are now, as charitable businesses, supporting provision for the most vulnerable and lowest paid members of society, charging a social rent that makes this viable and using what limited capital subsidy is available.

However, those with the capacity to bring added value to the marketplace and which choose to take this route will need to embrace a more highly geared and higher risk future. This will involve developing new funding models and being prepared to show real market leadership and innovation, in close collaboration with local authority partners.

These associations, and their lenders, will also continue to need a high degree of revenue certainty from the housing benefit system.

The business models they choose will vary. Some may develop off-balance sheet vehicles and/or form joint venture partnerships with private companies or with local authorities with a good level of financial headroom or with both. Some may decide their best option is to form a REIT. Some might look to a mutual model.

Housing associations which have the capacity to bring added value to the marketplace and choose to take this route will need to embrace a more highly geared and higher risk future. This will involve developing new funding models and being prepared to show real market leadership and innovation, in close collaboration with local authority partners.

Whatever the specific route, housing associations prepared to develop a more enterprising approach will need legal and governance structures capable of:

- delivering access to adequate levels of new finance
- taking quick decisions to achieve competitive advantage or at least maintain parity in the marketplace with more commercial organisations
- offering new forms of accountability to an increased range of stakeholders
- protecting the security, service quality and standard of accommodation of their social rented tenants.

Associations which embrace change will do so from unshakeable social foundations. But the reality is, in tough economic and financial conditions and with limited public subsidy available, even those which wish to carry on as now will not avoid risk. The nature of the risks will be different and of a different scale, but they will still exist.

Protecting and regulating public investment

Additional rent and asset management freedoms and flexibilities could create extra financial capacity for housing associations well in excess of £20 billion. In a new world of associations embracing a more enterprising approach to lead expansion of housing provision for a wider range of tenants, government will retain a legitimate interest in ensuring that historic public investment in the sector is captured, protected and recycled into new affordable below-market housing and regeneration.

> *Holding a social equity fund on the balance sheet and accounting year by year for its use would allow full transparent scrutiny of its application to ensure it was being used for public benefit.*

One way of achieving this could be to transfer new capacity generated from existing assets developed with government funding into a 'social equity fund'.

A new 'social equity fund'

As an illustration of how the value of such a social equity fund might be calculated, if the current rent on a housing association home is £100 a week, reviewing affordability on the basis of 35% of net income could lead to the rent being increased over time to, say, £120 a week. The additional £20 a week could support a loan of, say, £15,000. Each participating housing association would re-assess affordability based on income in this way for their entire stock, with the total value generated forming the social equity fund.

The fund's value for reinvestment would be 'hermetically sealed' by holding it as a contractual liability on the balance sheet of the housing association, in return for the new rent flexibilities created. It would be controlled by the association and ring-fenced for the specific purpose of supporting new development and regeneration activity for people needing homes at below market price.

As the social equity fund was utilised, its value on the balance sheet would reduce, eventually to nil. Holding it on the balance sheet and accounting year by year for its use would allow full transparent scrutiny of its application to ensure it was being used for public benefit. This could be enhanced by giving the fund mutual status, offering direct influence to residents and other key stakeholders.

Managed and accounted for in this way, such a social equity fund would offer a clear and objective measure of the embedded value of the freed up public investment in each housing association, against which its performance and value for money offer could be assessed.

With further work on its structure, the social equity model might be established as an assessment measure of asset and value for money performance for remaining charitable housing associations too.

There is also a live debate in housing circles around how the very substantial value of historic capital grant could be captured and re-utilised as some form of equity investment. The social equity fund could form one route for this discussion to be taken forward in more detail.

A new regulatory approach

The regulatory environment would need to adapt to be able to support the proposed new housing world. This could be achieved by building on the co-regulatory approach introduced in 2010 and factoring in the need to appeal to a broader range of providers.

All rented housing providers operating under the new regulatory framework and accepting a level of oversight of their activities would, in return, gain access to options such as discounted public land, some form of tax incentives and other subsidies in order to increase the provision of new homes.

Providers would guarantee tenancy standards, adopt a recognised governance code to ensure high quality strategic leadership, and be required to provide some assurance over their financial standing.

Private companies have their conduct regulated already in a variety of ways; they understand the concept of protecting consumer interests and public rights and investment. They would also gain from the reputational improvements to the MRS that regulation should help deliver. The key would be to ensure that regulation is no more onerous than necessary to achieve the stated goals.

With the right form of tenancies available, good incentives and carefully constructed market oversight, the door could be swung open for large scale private residential companies, housebuilders, pension funds - even supermarkets – to get involved in delivering the rented housing England needs.

Just as some housing associations will choose not to get involved, so there would be no compulsion on private landlords. Many small Buy-to-Let landlords would almost certainly sit outside of the new system, for example.

But with the right form of tenancies available, good incentives and carefully constructed market oversight, the door could be swung open for large scale private residential companies, housebuilders, pension funds – possibly even retail operators – to get involved in delivering the volume of rented housing England needs.

This could create the favourable conditions necessary for many more homes to be built for letting to people needing some form of below-market housing subsidy. It offers a route to delivering the size and nature of rented sector in England that can genuinely provide for the volume of people increasingly reliant on it.

Conclusion

The Government's Affordable Rent model is one new way to draw additional private finance into housing people who cannot afford England's expensive open markets.

Our view is that, given a return to higher capital subsidies is unlikely any time soon, a more sustainable model could involve driving growth and improvements in the market rented sector so it can supplement the traditional affordable housing sector more effectively, using new sources of finance and new, more attractive terms and conditions for tenants.

Even in difficult financial times, government can create a funding and operational environment that pulls more private investors into supporting new below-market housing delivery, and that offers housing associations new freedoms and flexibilities to maximise their role across the rental market, in close collaboration with local authorities empowered with greater freedom of manoeuvre in their local markets.

Housing provided at below market price will always need subsidy, but the choices government makes over the nature of those subsidies and their extent will make an enormous difference to what can ultimately be provided on the ground and to the choices and level of affordability that consumers enjoy.

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