Research Paper

International measures to channel investment towards affordable rental housing: English case study

authored by

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EXCHANGE RATES

Currencies are stated in British Pounds (£) and in Australian Dollars ($) converted at a rate of £1 = $1.8.

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ACRONYMS

AHURI	Australian Housing and Urban Research Institute Limited
ALMO	Arms Length Management Organisation
bp	Basis point (one hundredth of one percent)
EIB	European Investment Bank
EU	European Union
GFC	Global Financial Crisis
HCA	Homes and Communities Agency
LIBOR	London Inter-bank Offered Rate
LSVT	Large scale voluntary transfer
RPI	Retail Price Index
S&P	Standard and Poor's
SHG	Social Housing Grant
SPV	Special purpose vehicle
THFC	The Housing Finance Corporation
TSA	Tenant Services Authority
UK	United Kingdom
VAT	Value Added Tax (UK)

EXECUTIVE SUMMARY

This research has been commissioned by the Western Australian Government to describe and assess international models for financing the supply of affordable housing that use public subsidies and incentives to attract large scale commercial finance to the supply of affordable housing. This report provides the findings of stage 2B of the research which uses expert interviews and desk research to assess the growth and effectiveness of private finance in England.

Since the introduction of private finance in England in 1988, mainly in the form of commercial loans to housing associations, the funding models of the sector have been transformed. Lenders currently provide some £50 billion ($90 billion) of facilities for associations, including a small but growing market in bonds. This has allowed governments to progressively reduce the level of grant support to the housing association sector such that it is now just below the level of private finance. During the last two decades, associations have increased their professionalisation, innovated with new housing and community development approaches, increased housing supply, and developed a relationship more at arms' length from government. Therefore, the changes brought by private finance in England have been, within the terms envisaged by Margaret Thatcher's government in the late 1980s, highly successful.

However, the Global Financial Crisis (GFC)—a term used to describe the turmoil in property and financial markets triggered by the US sub-prime mortgage collapse in 2008—has led to a re-evaluation of private finance. In particular, tension has arisen between the government's desire to reduce grant assistance, and the sector's wish to keep commercial borrowing at manageable levels. Interviewees approached for this research considered that the decline in grants may have been too great, and led to associations taking on greater risks through market-rate sales, shared ownership schemes and speculative land-banking. For many larger associations these activities have become central to their business planning. Unfortunately, they are also activities that have become problematic with the downturn in English property markets.

Though English housing associations operate at a distance from government, the private financing system relies on government support. The sector is comprehensively regulated, failing associations are rescued, tenant incomes supported, and additional public funds injected at times of economic pressure. Though associations are not guaranteed by government, they benefit from layers of both explicit and implicit support. This is reflected in housing associations that use bond finance being rated as AA, a *high quality* risk assessment. Similarly, with commercial loans, lenders have been prepared to advance greater percentages against asset values, demand lower interest cover covenants and, until the GFC, charge margins that classify associations as of similar credit risk to prime corporate borrowers. One of the ironies of the approach in England is that private finance has only become viable at current levels due to consistent and strong support from the public sector.

There are many pitfalls inherent in copying policies between countries. These are great when, as between England and Australia, the social housing sectors operate at different levels of scale, capacity and government support. Furthermore, the financial systems in the two countries differ, with England benefitting from a more competitive commercial lending sector and capital markets with an appetite for social housing risk. From English experience, introducing private finance appears capable of bringing benefits such as greater professionalisation of housing providers and the creation of a broader coalition in favour of expanding affordable housing. The downside, evident during the GFC, is that reducing grant finance too low can lead to associations taking on greater risks that may not be sustainable during an economic downturn.

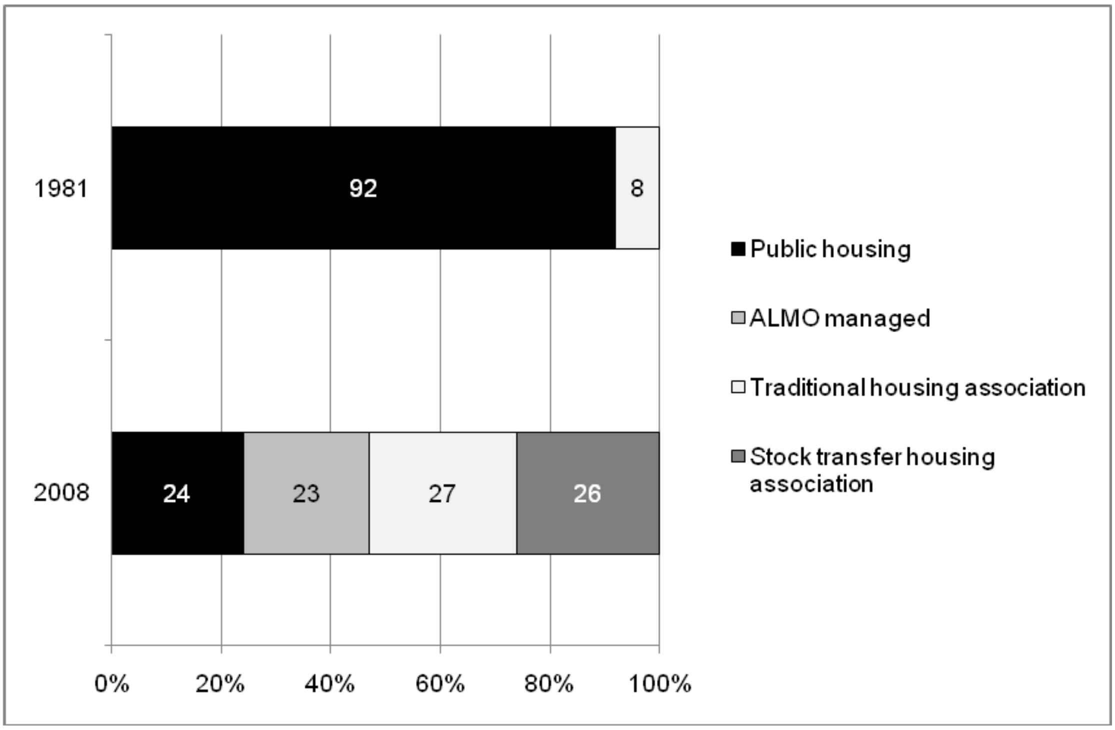
1 BACKGROUND

The affordable and social housing sector in England incorporates both public housing, provided by local authorities, a variety of other providers, such as non-profit housing associations, and arms' length organisations described below. This chapter describes recent changes in social housing provision, regulation and governance.

1.1 Social housing providers

During the past 30 years, the proportion of social housing has fallen from over 30 per cent to just below 20 per cent of total English households, mainly as a result of granting the 'right to buy' to sitting tenants in 1980. The composition of social housing has also changed significantly, as shown in Figure 1 below. Housing owned, managed and financed in the public sector has fallen from 92 per cent to 24 per cent of social housing stock. A further 23 per cent remains publicly owned though managed by non-profit organisations run at arms' length from local authorities (ALMOs). Housing owned and managed by non profit organisations—known as housing associations—has increased from 8–53 per cent of the social housing stock. Most housing association growth has been through the transfer of stock from local authority control. From the late 1990s, stock transfer program accelerated through Large Scale Voluntary Transfers (LSVTs), mainly in urban areas (Pawson et al. 2009).

Figure 1: English social housing restructuring, 1981–2008



Source: Pawson et al. 2010 (forthcoming)

Data on English rental housing stock is given in Table 1. The private rental sector, which accounts for 44 per cent of total rentals, contains both high-income and low-income households. Households on low incomes, regardless of landlord type, are supported through welfare payments, usually known as *housing benefit*, described in Section 4.4 below. Social rental housing is provided by a variety of landlords in the public and private sector, some covering many areas though many, especially public housing and ALMOs, concentrating within a single local government area.

Table 1: English rental housing landlords, 2009

Type of landlord	Dwellings ('000)	% of rental stock
Public housing (approx.)	950	14
ALMO managed (approx.)	880	13
Housing association (approx.)	1,967	29
Total social rental	3,797	56
Private rental	2,982	44
Total rental sector	6,779	100

Source: CLG 2009b; Pawson et al. 2010 (forthcoming)

Housing associations have become the dominant provider of English social housing. Although tracing their origins back several centuries, housing associations expanded rapidly after the *Housing Act* 1974 which provided generous public grants to build new social housing provided associations registered with the Housing Corporation. Until late 2008, the Housing Corporation, an arms' length national government agency with a separate board, acted as both funder and regulator of English associations.

There are 1700 English housing associations, though many of these own and manage fewer than 250 properties. Just under 400 associations manage over 1000 properties, accounting for 97 per cent of the homes in the sector (TSA 2009c). Merger between associations, and the relaxation in stock transfer size restrictions in 2004, has led to the growth of a small number of very large groups managing upwards of 40 000 properties (Pawson & Sosenko 2008). The housing association sector employed over 133 000 paid staff at the end of 2008 (TSA 2009f). Most associations are currently inactive in terms of developing new homes, with around 100 of the larger associations responsible for the vast majority of new development undertaken by the sector.

1.2 Regulation and governance

The body of legislation on affordable housing in the UK is considerable, in part because as new legislation is introduced, existing legislation often remains in place where it has not been superseded. The main pieces of current legislation are:

→ *Housing Act 1988*. Introduced the LSVT and encouraged housing associations to seek private finance through commercial loans and bonds.

→ *Housing Act 1996*. Contains the majority of current social housing legislation.

→ *Housing and Regeneration Act 2008*. Details recent changes to the regulatory environment in which housing associations operate.

English housing associations are closely regulated, with the remit of the Housing Corporation expanding since its formation in 1964. The Corporation also inspected associations until 2003 when it lost this role to the Audit Commission (2005), who also inspect local authorities (including their housing services) and ALMOs. Following the Corporation's dissolution in December 2008, their investment role transferred to the Homes and Communities Agency (HCA) and was integrated with regeneration activities. The HCA had an annual budget in their first year of £16.8 billion ($30 billion). Regulatory activities passed to the Tenant Services Authority (TSA), which by 2010 will also regulate public housing and ALMOs. These 2008 changes to English regulation might lead to a re-ordering of the social housing sector with a more 'level playing field' between providers, although it is too early to be certain (Gilmour 2009).

The TSA are continuing a system based on rules and regulations, supported by housing provider registration and transparency through disclosure of finance data and audit reports. Described by the Housing Corporation (2005, p.4) as ‘risk based regulation’, the system imposes lighter reporting and looser controls for smaller associations (below 1000 properties) or those judged after inspection to be less risky.

England brought market forces to the housing association sector through debt finance. According to Malpass (2000, p.183), the *Housing Act* 1988 ‘marked the beginning of the contemporary period’ for English housing associations. For Randolph (1993, p.39), it led to a ‘partial re-privatising’ of associations, moving away from reliance on public funding for development, with subsidies covering any management overspend. Grants were pared back to 75 per cent of construction cost and became increasingly targeted towards associations who could develop new homes, and manage tenancies, at the lowest unit cost (Walker 1998).

By leaving associations little choice but to borrow from banks, the 1988 Act leveraged significant private sector funding for associations to build new housing and to start clearing the considerable backlog in former local authority housing repairs using a mix of public and private funds (Barbato et al. 2003). Private finance was also used to fund LSVT stock transfers where the acquiring housing association had to purchase the local authority’s stock at a value based on its existing use. The use of private finance became particularly attractive to government when Treasury ruled in 1987 that loans to associations would not be counted as part of national debt. Hence, association loans remain off the government’s balance sheet in official statistics.

The introduction of private finance in 1988 had important consequences for the way that associations are run. Associations became more focused on collecting rents, and good financial management was needed to ensure sufficient funds to repay loans. English housing associations started a period of rationalisation, through mergers or joint working agreements (Walker 1998). Raising bank loans and managing development and market risk required increased professionalisation from the finance director, the management team and the board. Commercial loans needed new skills in negotiation, documentation and on-going monitoring through financial covenants. After 1988, the Housing Corporation expanded its role into capacity building, joined by a growing industry of private sector consultants, trainers, conference organisers and technical service providers (Gilmour 2009). In part to protect the sector and in part to make banks more comfortable lending to housing associations, the Corporation introduced further layers of regulation and monitoring. Paradoxically, ‘beneath the rhetoric of independence, flexibility and efficiency contained in the 1988 Act lay the sub-text of greater control by the state’ (Randolph 1993, p.56).

The development of the housing association sector in the last 20 years since the advent of private finance has been characterised by increased complexity and greater risk. Commercial loans expose an association to interest rate, refinancing and counter-party risks. The quest for profits from non-core activities has also increased risks from property market fluctuations and the risks in controlling complex corporate structures, such as off-balance-sheet joint ventures with commercial developers. Growing risk, and the need to achieve scale economies in financial management, have contributed to the trend towards mergers between associations. Most of the larger developing housing associations now have treasury specialists, whereas in the past these activities would have been undertaken by generalist finance staff. The regulator provides treasury management guidance and parameters, helping minimise risk (TSA 2009g). Other examples where senior staff have been strengthened is employing specialist sales departments for market and shared ownership programs.

1.3 Legal and tax status

Most housing associations are charitable. That is, they meet the requirements of English law for those bodies which, because of their benefit to society, are given favourable tax treatment. Also, most are incorporated either as companies limited by guarantee or as Industrial and Provident Societies. The common feature of both incorporated entities is that, while they are formed and owned by shareholders, those shareholders are not entitled to receive any distribution on their shareholding. Profits or surpluses of associations are used to meet the organisation's social objectives.

Housing associations are normally managed by paid executive staff though controlled by a board comprised largely of non-executive directors, often professionals from the fields of finance, accounting, the law, and property development. Many LSVT boards are structured with one-third of directors from the professions, one-third nominated councillors and one-third residents. Until recently, directors have not been paid for their role, and while many non-executive directors continue to undertake the role on a voluntary basis, increasingly boards are remunerated. The latest survey, although based on a small sample, showed 27 per cent of English housing associations remunerated board members (Insight 2008, p.3).

Tax arrangements for English charities are complex. Organisations undertaking charitable activities will not be charged corporation tax on any profits (surpluses) arising on those activities. However, where those activities are deemed to be undertaken for a purpose other than directly meeting charitable objectives, such as market-rate sales, there is the potential for a tax liability (Wood & Kemp 2003). Often associations have created special purpose corporate entities, usually subsidiaries, to undertake this type of activity. The profits of the non-charitable subsidiary will then be paid to the charitable status holding company to support its broader social objectives, in which case the payment is tax deductible from the subsidiaries' profits.

Until the early 1990s, charitable entities could fully reclaim Value Added Tax (VAT, similar to GST in Australia) paid on the purchase of goods and services, but since then this has not been possible. As a result, housing associations now typically are able to reclaim only a very small proportion of the VAT they pay. With VAT set at a rate of 17.5 per cent, this can add significantly to housing associations' costs.

2 HOUSING ASSOCIATION FINANCE

Despite longstanding philanthropic support for low-income housing in England, during the first half of the twentieth century, public grants became the principal funding source for social housing built by organisations other than local authorities. Grants to housing associations expanded after 1974, and have been known since 1996 as a 'Social Housing Grant'. The 1988 *Housing Act* introduced private finance, moving associations to a mixed model of public grants and private bank loans. With the 2004 *Housing Act*, for-profit organisations have been able to bid alongside associations for a Social Housing Grant, though few have.

What has emerged, therefore, is essentially a corporate model for the funding, development, ownership and management of English affordable housing. This is distinct from a project-financed-based model, since the private sector funders basically look at the strength of the borrower rather than a project finance model where a bank or investor will look at the assets and cashflows associated with a specific housing development. This latter approach has been adopted in a number of countries, most noticeably the US. While England has adopted some project-finance-based models over the last 20 years, these have mainly been used for regeneration, not new supply. The predominant model, and the one responsible for most of the affordable housing developed over the last 20 years, is one that utilises the strength of a housing association's cashflows and balance sheet to raise debt finance.

Most new housing association construction prior to 1988 was funded by government grant and a very limited amount of government provided debt. Following the relaxation of borrowing controls, the past two decades have seen a dramatic decrease in the amount of grant funding from government and an increasing reliance on the role of loans, the planning system, and cross subsidy. By March 2008, the level of private debt funding to the sector exceeded public grants for the first time (TSA 2009c). Reliance on the planning system and property sales have made the social housing funding model increasingly dependent on a buoyant private property market, and the property crash of the last 18 months has provided new challenges.

2.1 Social Housing Grant

As the government sets rents for social housing at sub-market levels, the construction cost of new social housing is so high relative to the future expected rents that housing associations would not be able to develop new housing with grant assistance. Theoretically, a Social Housing Grant needs to be repaid to the government if grant-funded assets are sold, though there is provision for associations to recycle the grant for the provision of new social housing. However, the government is not paid any interest on the grant while it is held by the housing association, nor does the government receive any upside from the assets if they are sold at a profit (although this latter issue is under consideration by the regulator). Given this analysis, the cost of a grant varies depending whether viewed from the perspective of an association or the government. For a housing association, the cost of grant funding is zero. From the government's perspective, however, a grant has the following costs:

→ Government needs to issue debt to fund a Social Housing Grant. The cost of this money should be viewed as the prevailing long run UK government bond rate, and for most circumstances this money will need to be borrowed in perpetuity.

→ A government grant is subordinate to the debt finance obtained by housing associations. As such, the added risk borne by government should be considered when determining the cost of the grant that it is providing.

- As there is a limit to the amount of money that government wishes to borrow, if funds are invested in a Social Housing Grant they cannot be used elsewhere. This opportunity cost argument suggests that the social return for government from additional social housing should be higher than the social return elsewhere.

While a grant does not produce a financial return for government, government does expect a 'social return' from its investments. The quantifiable social return that government receives for its grant contribution is the provision of more housing at sub-market rents. The unquantifiable social return is that the provision of social housing stabilises communities, minimises homelessness, improves health and supports social cohesion. To this end, over recent years associations have become increasingly involved in initiatives beyond the provision of bricks and mortar.

The process of applying for, and monitoring the use of, a Social Housing Grant is closely controlled by the HCA. The grant is paid directly to housing associations, or occasionally to one association on behalf of others through a consortium. The HCA negotiates with government on the level of the Social Housing Grant and funding priorities. It seeks bid submissions from associations who put forward proposals for new development of affordable rented or low-cost home ownership units. The method and timing of grant allocations change from time to time. At present the National Affordable Housing Program runs over a three-year period. In Autumn 2007, the HCA requested funding bids for the three-year program during 2008–11. During the three-year period, further bids can be made for new projects under a *Continuous Market Engagement* program, or for specific schemes such as *Kick-Start*.

When making a bid for funding, the housing association has to submit detailed project information on all projects it is seeking a grant for, and confirm that it will comply with a number of different standards and requirements. A grant is distributed on a competitive basis, with those housing associations willing to undertake projects for the smallest grant rates usually receiving most of the government funding for new development (Whitehead & Williams 2009). The general requirements for grants are:

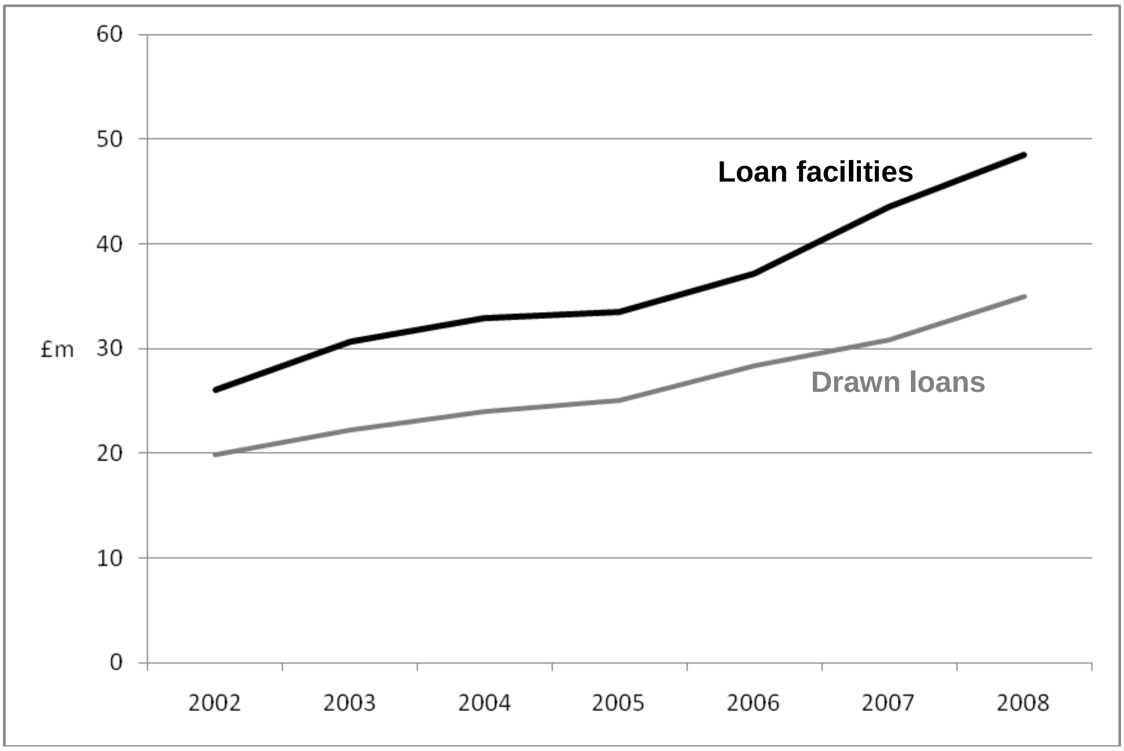
- *Policy*. All bids need to be in line and supported by the local authority where the development is proposed. The tenure mix for rented and low cost home ownership has to be agreed to meet priority local needs.
- *Quality.* The project has to meet the Design and Quality Standards published by HCA with required 'housing quality' indicators which cover issues such as location, visual impact and layout, open space, size, noise and accessibility. The minimum is Code for Sustainable Homes Level 3, a UK benchmark of environmental efficiency of residential development. This is likely to be increased to a more demanding standard—Level 4, from March 2011.
- *Value for money*. Rent levels have to be submitted as part of the bid and must be in line with national rent policies. The project details submitted at bid stage confirm the total project costs and the level of grant funding needed for the part of the project the housing association cannot meet from loan funding based on the net rental income, or its own funding. HCA use an Economic Assessment Tool to evaluate bids. There is currently no set or target level of grant applied to projects.
- *Deliverability.* The delivery timetable and certainty of delivery are important criteria. If the site is already owned and has planning permission then it is more likely to be considered for funding. The association has to confirm the milestone dates to achieve key delivery events, and is measured against these.

Once grant allocations are confirmed, a formal agreement between HCA and the housing association is signed, committing the parties to the delivery of the program to agreed levels of funding and timetables. After confirmation of allocation, the housing association can proceed with the project subject to making further submissions, for example with details of proposed land acquisition. The association could proceed without grant confirmation, but this would be at their own risk. Part of the grant is payable at the start of the building works (currently 60% of the total) and the remainder at completion of the works. At each stage, the association has to re-confirm the project details and if there are any changes these have to be approved by HCA. This allows a degree of flexibility required to deal with the uncertainties of the property market and the planning system which can require project amendments. A system of monitoring, control and audit is in place allowing the HCA to verify that the grant is being spent as planned and that results are being delivered.

2.2 Commercial loans

With grants pared back since 1988, housing associations had little choice but to borrow from banks. This option became particularly attractive to government following a Treasury ruling that loans to associations would not be counted as part of national debt. As at March 2008 the aggregate drawn borrowing of housing associations managing more than 1000 properties was £34.9 billion ($63 billion). This is slightly ahead of the £34.4 billion public loans through Social Housing Grant. There are some £15 billion ($27 billion) of funds available under existing loan agreements that have not yet been drawn (TSA 2009c, pp.16–17). Commercial loans to housing associations have continued to increase during recent years, as shown in Figure 2 below.

Figure 2: Loan facilities and drawn loans, March 2002–March 2008



Source: Housing Corporation 2006; TSA 2009a—data as at 31 March

In general, housing associations arrange debt finance based on the quality of their existing assets, their perceived ability to make future interest/principal payments, and the strength of government support for the sector. As such, housing associations do not approach banks and other debt providers with specific development schemes that require specific ring-fenced funding. Consequentially, schemes are not generally funded on a *project finance* basis, rather as a mix of properties and cashflows as would be typical for a loan to a private sector company. It is common for associations to maintain a pool of committed, undrawn funding to help meet the needs of their development programs—the gap between the two lines in Figure 2.

In the typical commercial lending situation, a bank will make available an agreed sum or facility to a named housing association. Most housing associations have traditionally sought to match their long-term assets with long-term borrowing, and so have usually arranged facilities which are repaid over a period of up to 30 years. These are longer loans than normally made available to commercial borrowers. In considering whether to lend and on what terms, the bank will consider:

- The nature of the housing association. Stock transfer associations are seen as riskier than more traditional associations, and will be subjected to tighter terms.
- The strength and experience of the management team.
- The associations' business plan, to ensure that debt can be repaid out of net cashflows and that key financial indicators are in line with sector norms.
- The quality and value of the stock, and conformation that there are no title issues that would prevent the bank obtaining a fixed legal charge over assets.

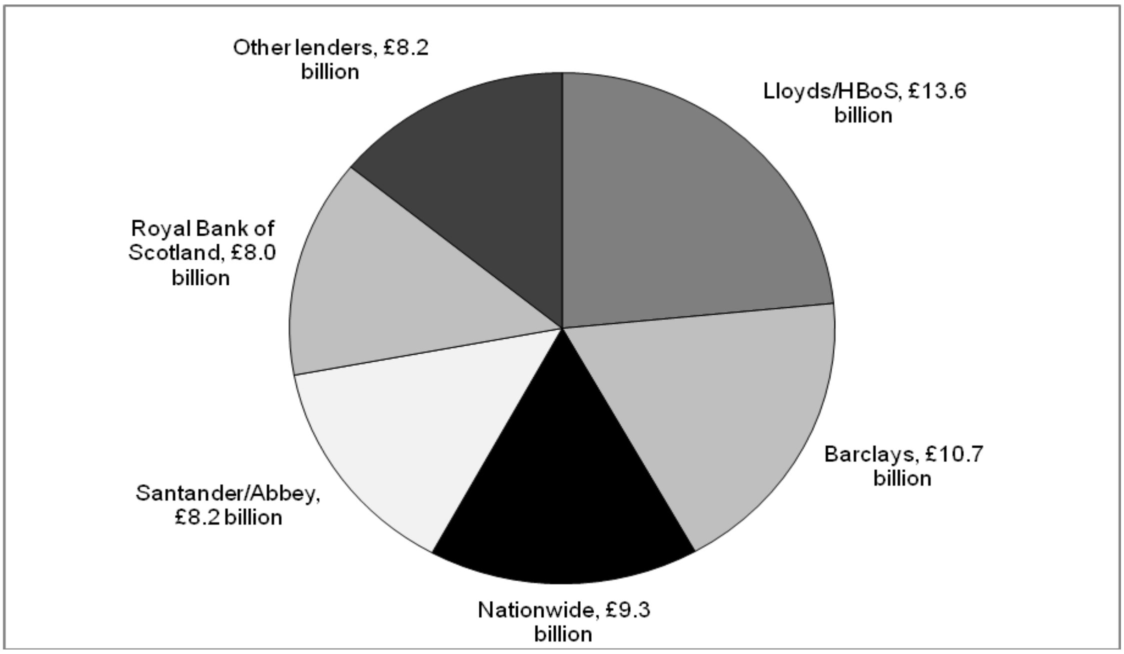
The bank's assessment of these and other matters will determine whether it is prepared to lend at all; what the terms, including price and covenants will be, and what the prudential limit for lending to a single association will be. Absent from this list is any detailed assessment of individual housing schemes, which reinforces that the focus of the lender is on the strength of the association itself, its corporate (i.e. total) cashflows and its balance sheet. Many loan agreements will allow for an association to draw down funds for any purpose that they can legally undertake. Most of an association's activity is in the construction and management of affordable housing, though the bank does not closely monitor how associations apply borrowed funds.

Monitoring of the relationship will take place periodically, usually with at least one meeting over the course of a year. Agenda items might include: business update; any large or unusual schemes; financial performance in the previous year; forecast financial performance in the current year; the business plan; and any reports from the regulator. The banks will be looking to gain general comfort that the organisation is being well run, and will be alert to any early warning signs of underperformance.

Since 1988, the market for commercial loans to housing associations has become more competitive, though there have been problems following the GFC, which are described in more detail in Section 6.1. As at December 2008, some 85 per cent of lending to the sector was dominated by five financial institutions, as shown in Figure 3. The main lending institutions to associations are banks and building societies that already have a strong presence in the general UK banking market across all sectors. Therefore, commercial lending to housing associations has become a mainstream, regular activity of most of the larger UK financial institutions.

The growth in lending to housing associations has occurred as they have become viewed as stable borrowers by lenders. Associations have stable social rent cash in-flows that are seldom subject to market volatilities as demand for social housing has always exceeded supply. The demand is so great that the government estimates that England needs an additional 50 000 new social rented units per year just to keep up with demand (Housing Corporation 2007b). Furthermore, as the subsidised rent levels are regulated by government, and increased at a slightly higher rate than inflation, housing association businesses benefit from some protection against price pressures in the provision of housing services and repairs. However, although housing association core rental cashflows are stable, which should allow for increasing leverage with lower risk than in entities that have more volatile cashflows, the ultimate level of borrowing is constrained by the low rents charged to tenants.

Figure 3: UK facilities to housing associations, December 2008



Source: Social Housing 2009b

The social housing regulator is extremely powerful compared to other sectors of the economy. If the regulator is unhappy with an association's financial viability or governance, it can replace board members with TSA nominees, remove failing executives, and place the troubled housing association on a stronger footing. Even if financial difficulties occur unexpectedly, as happens from time to time, the regulator leans on a stronger housing association to take over the failing organisations. If this happens, the commercial loans are therefore moved to the stronger housing association, thus avoiding lender losses. The regulator can (and has) provided financial guarantees and an additional grant to bail-out failing housing associations.

An important consequence of these factors reducing risk is that lending to housing associations is beneficial to lenders under their Basel II capital adequacy regulations. Lenders receive a 'risk weighting' on association lending of 15–20 per cent compared to a 50 per cent risk weighting on conventional corporate loans. This reduces the cost of lending, allowing banks and building societies to provide debt at lower margins to housing associations while still maintaining the same profit (Whitehead & Williams 2009, p.10). This is in addition to the regulatory support which ratings agencies, such as Moody's Investor Services, consider to show government support of the sector:

> Moody's ratings in this sector continue to benefit from a strong regulatory framework and the embedded high probability of intervention from the government of the United Kingdom (Aaa/stable), were housing associations to face severe financial distress … Moody's therefore expects that government will mobilise resources as necessary to protect tenants and to maintain the financial stability of the housing association sector, in order to maintain its key role in social policy'. (Moody's 2009b, pp.1–2)

The GFC has had a significant impact on commercial lending to housing associations. An undisclosed number of associations have had to seek covenant waivers from their funding banks. Unlike in the past when such waivers were provided without an increase in margin, interviewees for this report have cited examples of margins increasing from 0.25 to over 2 per cent. While offset by low LIBOR rates at present, in the future this will result in an increase in the interest bill paid by associations, which will put further pressure on future covenant performance and will reduce the sector's capacity to develop new homes. The UK government has been forced to spend £2.8 billion ($5.0 billion) to the end of 2008 to re-capitalise housing associations, with some of the largest recipients requiring over £250 million ($450 million) to maintain solvency (Inside Housing 2009, p.9). However, from Table 2, the sector's cashflows to 2014 appear such that there will be a peak of demand for new and additional private finance in 2008–10, reducing in subsequent years.

Table 2: Private finance forecast, 2009–10 to 2013–14

	2010	2011	2012	2013	2014
Acquire and develop housing	7.05	5.61	4.49	3.74	3.56
Less sales receipts	-0.89	-0.92	-0.82	-0.82	-0.75
Grants received	-2.81	-2.51	-2.14	-1.79	-1.56
Net cost new developments	3.35	2.18	1.53	1.13	1.25
Major repairs expenditure	0.47	0.49	0.57	0.68	0.82
Loan repayments	0.82	1.07	1.12	1.22	1.01
Stock transfers	0.30	0.20	0.20	0.20	0.20
Other funding	0.20	0.20	0.20	0.20	0.20
Private finance requirement	5.14	4.14	3.62	3.43	3.48

Source: TSA 2009d, p.9—figures in £ billion

2.3 Bond issues

Although considerably smaller in total amounts raised than through bank loans, bonds offer an alternative source of longer term debt for associations. Bonds are typically purchased by institutional rather than private investors, and normally issued in a minimum size of £100 million ($180 million). Although not underwritten by government, the bonds benefit from the same protections for housing association income and assets described in the previous chapter. Bond investors, unlike commercial lenders, pay less attention to the associations' underlying trading, with greater reliance placed on regular assessments by rating agencies such as Moody's Standard and Poor's (S&P) which use the code shown in Table 3 below.

Table 3: Bond rating codes

Moody's	S&P	Credit quality	Credit risk
Aaa	AAA	Highest quality	Minimal
Aa	AA	High quality	Very low
A	A	Upper-medium grade	Low
Baa	BBB	Moderate credit risk	Medium
Ba	BB	Speculative elements	Substantial
B	B	Speculative	High

Source: Moody's 2009a
Table excludes C rated debt. S&P can add a '+' or '–' to above ratings (e.g. AA+, AA, AA–). Moody's rank by suffix, for example (Aa1, Aa2, Aa3)

Housing associations that issue bonds directly, referred to in this report as bilateral bonds, require ratings by credit agencies. While pricing and market conditions can critically influence investor appetite for bonds, the rating of individual English housing associations has in the past remained relatively stable (Berry et al. 2004). This has been less true during the GFC. Table 4 below shows the credit rating of the principal associations raising bilateral bonds in the last 18 months, with all classed to have a 'high quality' credit rating with 'very low' credit risk. They are just one step below sovereign (government) risk of major economies, traditionally Aaa/AAA.

Table 4: English housing association bond ratings

	Stock	Rating	Outlook
Sanctuary Group	70,000	Aa2	Stable
Affinity Sutton Group	53,000	Aa2	Stable
Places for People Group	53,000	Aa3	Stable
Circle Anglia	52,000	Aa3	Stable

Source: Moody's 2009b, p.12 and websites of the individual housing associations for total housing stock managed. 'Rating' refers to long term debt status

The three main bond types that are relevant to English housing associations are detailed below. The main differences in bond type relates to the mix of investors and the mix of borrowers. *Bilateral bonds* are issued to several investors by a single borrower, contrasted with *syndicated bonds* which have multiple borrowers. Private *placements*, by contrast, are a direct issue by one borrower to a specific investor. The former two categories result in market traded investments where more information is publicly disclosed. Table 5 shows the larger traded bonds issues still available in the market as at November 2009. These vary considerably in their size and issue yield, though are consistent in having a high credit rating. As bonds often have long term maturity dates, they often remain in the market for a considerable period of time.

2.3.1 Bilateral bonds

Larger housing associations are able to raise their own bond finance. This can be attractive as a supplement to commercial loans as there are fewer limits to the size of a bond issue, as banks will normally not take exposures to single counterparties through direct lending greater than £100 million ($180 million). For larger groups that have growth through LSVT and mergers, these sums are relatively modest. Bonds have been arranged for several large English housing associations. For example, Sanctuary Housing, who manages 42 000 properties, raised £200 million ($360 million) through a 30-year bond in March 2009. Sanctuary were re-rated to A+ from AA– by S&P in July 2009. Bilateral bonds are unlikely to be an alternative for smaller and medium sized associations due to their complexity and cost of issue.

While an interest cover ratio (income available to pay interest divided by interest paid) of between 9.5 and 12.5 times would normally be required to attain an AA bond rating for a corporate, the AA rated housing associations in Table 4 above have interest cover of around 1.5 times (Damodaran 2005, p.139), While some rating agency acceptance of lower interest cover ratios stems from stable rental cashflows and the fact that associations routinely hedge 80 per cent of interest rate risk, the regulatory framework is the main reason (see Section 4.1). This corresponds with corporate finance theory which indicates that entities can take on higher levels of debt when there is regulatory protection, stable cashflows and conservative hedging policies (Damodaran 2005).

Table 5: Housing association bond issues over £100 million, November 2008

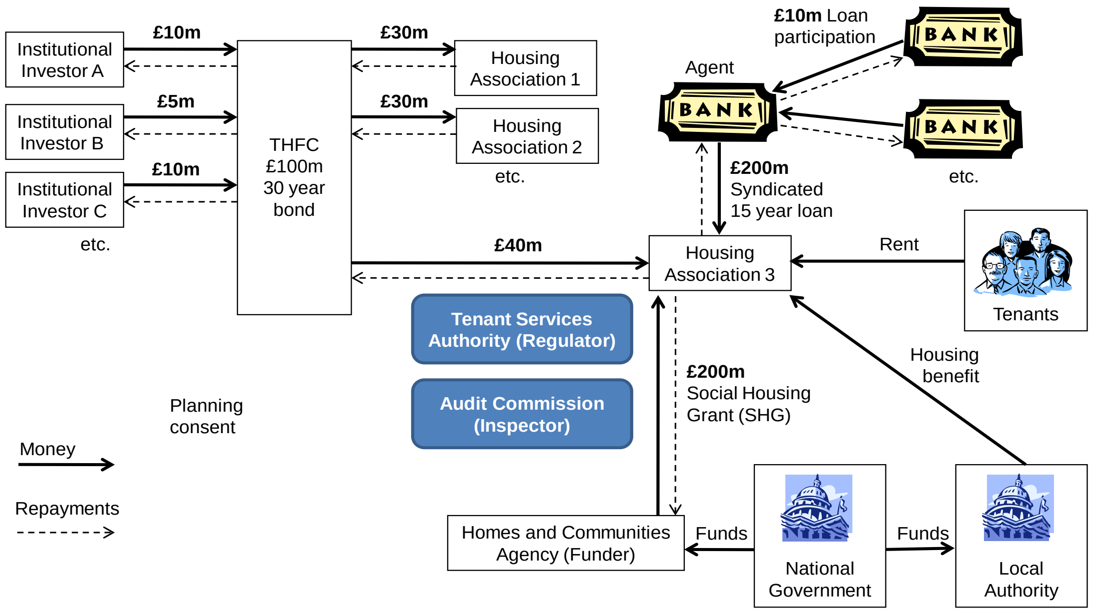
	Rating	Issue date	Nominal (£m)	Issue yield (%)	Issue margin (bp)	Yield (%)
FRESH Series One A1	none	03/97	£728.0	8.37	60	5.70
Places for People	Aa2/AA-	12/08	£348.0	6.96	285	5.62
Housing association Finance (No 1)	Aa3/AA-	06/03	£342.9	5.37	95	5.60
Haven	Aa3/AA-	08/00	£329.4	6.78	200	5.50
Harbour Funding	Aa3/AA-	08/03	£276.3	5.28	58	5.61
Circle Anglia	Aa3/–	11/08	£275.0	7.25	270	5.58
Affinity Sutton	Aa2/–	09/08	£250.0	5.98	155	5.71
THFC (Funding No 1)	–/AA-	07/08	£249.0	5.96	135	5.70
SHG Finance	Aa3/AA-	06/01	£240.0	6.38	138	5.81
THFC	none	10/92	£231.5	11.11	182	4.72
THFC	none	01/02	£225.3	5.65	100	5.53
Sanctuary	Aa2/A+	03/09	£200.0	6.69	260	5.66
Housing association finance	Aaa/AAA	06/05	£192.3	4.84	56	5.37
THFC (Funding No 2)	–/A+	06/09	£191.0	6.58	185	5.67
HSL	none	01/00	£185.8	6.35	150	5.35
FfH	none	10/93	£183.0	8.34	125	5.21
Housing association CO	none	09/94	£141.5	10.48	170	4.99
THFC (SHF)	none	07/98	£130.4	6.70	108	5.64
Quadrant HF	Aaa/AAA	02/98	£130.0	6.92	86	5.68
Housing association LOS/GESB	Aaa/AAA	11/93	£125.0	8.45	128	5.14
Northern Counties	Aaa/AAA	01/95	£110.0	6.34	80	5.68
Sanctuary	Aa2/AA-	05/98	£110.0	6.76	90	5.65
Places for People	Aaa/AAA	09/95	£105.0	8.74	70	4.95
Haven	Aa3/AA-	05/98	£100.5	6.95	95	5.52
Home	none	07/93	£100.0	9.18	110	5.66
Guinness Trust	Aa2/AA-	11/97	£100.0	6.30	95	5.54
Places for People	Aa1/AA	05/98	£100.0	6.58	87	5.55

Source: Social Housing 2009b; Markit, Royal Bank of Canada Capital Markets, Royal Bank of Scotland data analysed by Mark Washer

2.3.2 *Syndicated bonds*

Bonds are offered by the Housing Finance Corporation (THFC) and other bond syndicators, where the institutional investors' risk is spread across numerous recipient housing associations. The Housing Corporation and the National Housing Federation (the English housing association trade body) established THFC in 1988 to raise longer-term bond finance for the approximately 400 medium sized associations in England, Wales and Northern Ireland (THFC 2009b). Their role is shown in Figure 4 below.

Figure 4: Example THFC bond finance



In this hypothetical example, THFC issue a £100m 30 year bond with funds received from a number of institutional investors. THFC use the proceeds to fund three housing associations: this diagram relates in detail to Housing Association 3. This association's main debt finance, a £200m 15 year loan, is managed by an agent bank who has syndicated the exposure to a number of other banks who provide a smaller amount (for example £10m). The association receives SHG from the Homes and Communities Agency, is regulated by the Tenant Services Authority and inspected every couple of years by the Audit Commission.

THFC is a non-profit organisation, operating without government control, subsidy or guarantee of indebtedness. Rather, THFC are assessed by credit ratings agencies and their bonds priced accordingly. An example transaction is shown in Table 6.

Table 6: Example THFC bond issue

Issuer	THFC (Funding No2) Plc, a wholly owned subsidiary of THFC.
Date	July 2009.
Product	£191 million ($344 million) 6.35% secured bonds 2039/2041.
Rating	A+ (S&P), same as rating for THFC.
Security	First floating charge over assets of the issuer and parent company.
Covenants	Minimum asset cover 150%; Interest cover 100%.
Manager	Royal Bank of Canada and Royal Bank of Scotland, jointly.
Recipients	Southern Housing Group (£100 million), A2 Dominion (£50 million), Genesis (£30 million), Leeds Federated (£6 million), Portal (£5 million).
Outcome	Significantly oversubscribed—bids totalled £460 million.

Source: RBS 2009

S&P have rated THFC as ‘A+ stable’ rating over the last four years and maintained their rating in their latest review in 2009. All THFC assets are charged by fixed or floating security from housing association borrowers and available to support all THFC indebtedness, therefore a single credit rating is given to THFC. THFC’s rating is as good as or slightly better than associations raising bilateral bonds.

THFC evaluate the credit worthiness of each borrower, and the associations’ performance is monitored for compliance with loan covenants. This is an additional layer of control beyond an associations’ standard regulatory and inspection controls. THFC raise their funding from a variety of sources. Bonds are the most significant component, though they vary in type and in the past included zero-coupon, deep discounted bonds and private placements. One third of THFC funding is from banks, often for periods up to 25 years. Bank loans to THFC totalled £617 million ($1.1 billion) at March 2009, with an addition of some 16 per cent of funding provided by the European Investment Bank (EIB), a non-profit investor promoting urban regeneration schemes. The steady growth of THFC income and surpluses is shown in Table 7.

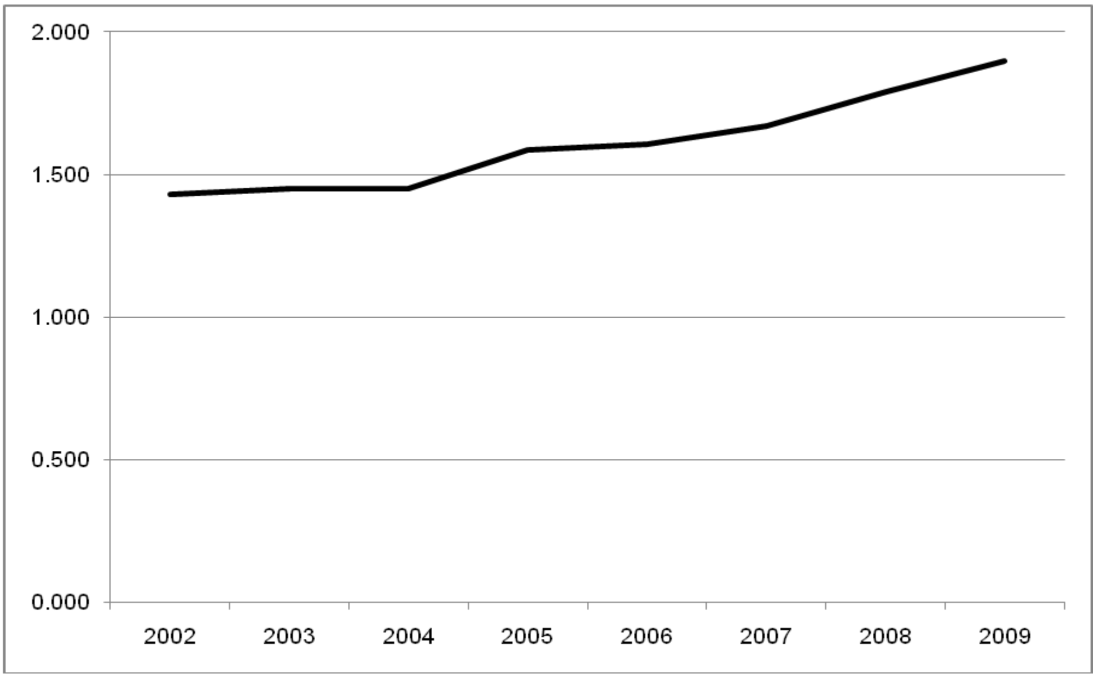
Table 7: THFC financial highlights, 2005–09

	2005	2006	2007	2008	2009
Total revenues	1,853	2,276	2,169	2,530	2,849
Surplus after tax	266	453	387	760	841
Cumulated surplus	6,043	6,496	6,883	7,634	8,484

Source: THFC 2009a—year to 31 March, figures in £ thousands

As at March 2009, THFC provided £1.90 billion ($3.42 billion) of loans to 188 housing associations. The loan portfolio grew rapidly during the 1990s, when conventional bank loans were expensive, but more slowly since 2000 when increasing numbers of banks entered the market of lending to housing associations (see Figure 5).

Figure 5: THFC loan portfolio, 2002–09



Source: THFC 2006; 2009a—year to 31 March, figures in £ billions

Total THFC loans have increased by about 4 per cent annually since 2002, when the portfolio was £1.47 billion ($2.65 billion) as shown in Figure 5. Of current loans, 43 per cent by value are to the top 50 English associations by stock holding. THFC loans are used by six of the top-ten English groups, including three associations that issue bilateral bonds. Loans at March 2009 ranged in size from £202 000 ($364 000) to Agudus Israel Housing Association, to £48.6 million ($87 million) to Midland Heart (THFC 2009a). The loan portfolio is distributed as a small number of very large loans (over £20 million, $36 million) to mid-sized housing associations, with a larger number of modest loans to smaller and regionally based English housing associations.

2.3.3 Private placements

Contractually similar to bonds, private placements are debt instruments offered direct through a broker acting on behalf of an association to a small number of institutional investors. For example, Places for People raised £130 million ($234 million) in December 2009 from US investors (Social Housing 2009a). Private placement involves lower fees than traditional bonds, in part as they are not underwritten. The minimum private placement would be for £50 million, $90 million (Dowler 2009).

2.4 Other finance sources

Social Housing Grant and private finance through commercial loans and bonds are by far the most important finance sources for English housing associations. However, other alternative forms of funding play a role, as described below.

2.4.1 Retained earnings

Although the vast majority of housing associations are charitable and prevented from distributing profits, many associations generate profits to undertake new developments, improve existing properties and support community initiatives. There is no market for ‘private’ equity within the housing association sector, though associations can build their capital base through accumulating trading surpluses, and by revaluing their properties at current market values. In practice, as most housing association equity is locked up in the existing property portfolio, new developments are funded through a mix of new debt and government grant. Older assets, which were funded by low or zero levels of debt, have a positive net present value. By contrast, newer stock is more likely to make losses over its forecast life.

2.4.2 Cross subsidy through shared ownership projects

While most new English social housing stock built today is for rent at below-market rates, a proportion uses the shared ownership model. This involves the participant purchasing a share of a property at market prices, then renting the remaining share from a housing association at sub-market levels. The aim is for individuals to purchase a greater share of their property over time (also known as stair-casing), leading eventually to their ownership of the entire property. The growth of shared ownership has increased housing association exposure to market risk.

Shared ownership, introduced by the Housing Corporation in 1981, was seen to meet the Corporation’s social objectives by filling a gap in housing need. It enabled people on lower incomes who would not be eligible for affordable rented accommodation, to access the property market for the first time. Property prices in many English regions require mortgages of many multiples of earnings, making them inaccessible to many younger people. The recent fall in English property prices over the last 18 months has reduced the problem, but it still exists.

With shared ownership, the sale of the initial share to purchasers represents a major source of revenue for the development project. Since the introduction of shared ownership, sales of *first tranches* (the initial 25% to 40%) have generated considerable profits for the housing association sector. These profits are absorbed into balance sheet reserves, and as such are applied to further their social objectives. In addition, as purchasers stair-case over time the portion of the property owned, further profits are made by associations. However, the timing of these cashflows to associations is unpredictable, as is the value realised that is determined by the prevailing market rates. Profits are greater during times of rising property prices.

The cohort of people eligible to use shared equity schemes has changed over time. Initially schemes were only offered to housing association and local authority tenants. This then changed to an emphasis on key workers, and currently there is a broader definition of people defined as those who cannot afford to buy a suitable property on their own in an area where they have a local connection. Household income levels have also gradually increased, to £60 000 ($108 000) with some discussion in London of increasing to £72 000 ($130 000). Many English regions have introduced 'one stop shops' to assist purchasers register for schemes and understand risks involved.

2.4.3 Cross subsidy through outright market sale

More recently, a number of housing associations that develop new properties have taken advantage of the potential for profits to be generated from open market sales. The regulator has adopted a permissive approach to associations developing private housing for sale provided it only represents a minority activity. The regulator's approach is supportive as such sales have contributed to funding affordable housing development at a time when grants have been falling. The importance of market sales was confirmed by interviewees who noted, for example, that of the 1300 properties developed by Affinity Sutton Housing Association each year, one quarter are for market sales and shared ownership. Each sale is said to generate around £20 000 ($36 000) profit, used to cross-subsidise the association's internal cost of producing a further two affordable rental properties. Some housing associations are said to have over half their new developments devoted to market sales and shared ownership.

The downturn in property markets during the last 18 months has had cashflow repercussions for a number of housing associations using this cross-subsidisation approach (Cooper 2009). Developing housing associations who rely on market-rate sales to part fund affordable housing were said in June 2008 to be falling short of the regulator's target for new building (Inside Housing 2008).

2.4.4 Use of the planning system

Section 106 of the *Town and Country Planning Act* 1990 created a framework for the development of affordable housing which has helped produce significant numbers of new homes in England. These agreements are a way of delivering or addressing matters that are necessary to make a market-rate development acceptable in planning terms for a local authority. They are increasingly used to support the provision of services and infrastructure, such as highways, recreational facilities, education, health and more recently affordable housing (Whitehead 2007).

A council's s.106 policy is usually set out in a Supplementary Planning Guidance or their Local Development Framework. Although there have been attempts in London and in some other cities to create a city wide approach, these attempts have generally failed and application of s.106 remains within an individual local authority's control. As such, there is no common model of how s.106 applies to affordable housing. Furthermore, the role of the planning system is limited during periods of economic dislocation, as there is little development gain (Gurran et al. 2007).

Some local authorities apply a percentage of the development required as affordable housing with a defined value that a developer is able to charge for the affordable housing. In effect, the land value is depressed by the value of the affordable housing. In some cases this value is set low enough for the affordable housing to be supplied without a Social Housing Grant. This is generally only viable in areas where market housing is very expensive. In most cases, some level of grant is required to 'top up' the s.106 subsidy (Monk et al. 2005). Other local authorities do not want much (or any) affordable housing and use s.106 to raise *payments in lieu* for other outcomes.

2.4.5 Local authority loans

Before the 1988 *Housing Act*, small loans from local authorities to housing associations were quite common, and many still exist. More recently, in October 2009 a Scottish local authority approved a £25 million ($45 million) loan to the East Lothian Housing Association, subject to ratification by the Scottish Government (East Lothian Council 2009). The council were able to borrow funds from the UK Treasury at a lower rate than the association could direct from the market. The council, therefore, on-lent funds to the association at the same rate, subject to a small administration fee. Funding is to be used to support the building of social housing which has already been approved by the Scottish regulator. It is not clear whether this will be an isolated example, or part of a new trend in association finance.

2.5 Housing association capital structure

In 2007, the then regulator, the Housing Corporation, outlined their view of housing association optimal capital structures by 'examining how much further the financial capacity of housing associations could be stretched to take on additional debt … [to promote] a further shift in the balance between government funding and private borrowing' (Housing Corporation 2007b, p.3). Their conclusion was that housing associations should increase debt by £4.6 billion ($8.3 billion), or by £6.8 billion ($12.2 billion) taking into account profits generated through open market sales. This would reduce the amount of Social Housing Grant required for new developments, and help bring down government borrowing as association borrowing is not classed as government debt. The cost premium for 'hiding' public debt within housing associations has historically been quite low, as the pre-credit crunch costs of new 30-year housing association debt was in the region of LIBOR + 25 basis points.

This approach has a number of risks. Higher debt would lead to associations having lower interest cover ratios, potentially leading to a breach of existing loan agreements. The ability of developing housing associations to maintain landbanks to facilitate future housing development, and fund community schemes, may be curtailed. Hence the 2007 report was unpopular with the sector, and did not lead to higher debt levels. It highlighted the tensions between an association's desired capital structure (low debt) and the government's approach (low grants). In this equation, government has the power to set grant rates, and housing associations have the power to decide if these grant rates are sufficient to justify new building projects. Ultimately, the result of this balance is that the more grant that is provided by government, the more housing will be provided by the charitable housing association sector.

There is no recommended capital structure that would suit every single operator within a sector of the economy (e.g. construction, manufacturing) due to the differences between individual strategies, underlying business efficiencies, growth plans, management capabilities, and historic assets/liabilities. Similarly, there is no recommended capital structure that would fit all housing associations. However, it is possible to outline general approaches to capital structure for an individual housing association, and to assess the likely differences between this structure and the capital structure recommended by the Housing Corporation's 2007 paper.

As an association cannot raise new equity, or obtain a new Social Housing Grant unless it develops new housing, the main choice confronting an association when designing its capital structure is whether to continue to build new housing. New housing will result in taking on more debt, more grant, and diluting existing equity as a percentage of the association's capital structure. Alternatively, the association could stop building new housing, which will eventually result in a pay down of debt and an increase in equity as a percentage of total capital. Such a decision will need to be based on careful business planning, scenario modelling and a calculation of the interest cover ratio over a 30-year period. For most housing associations, this forecast will start with very low interest cover in the early years of the plan, gradually improving as debt is repaid. Importantly, the association should stress-test the model against negative movements in the property market, delays in the sale of new properties, cost overruns, changes to interest rates and movements in inflation.

While most housing associations undertake stress-testing of changes in interest rates, inflation, and cost overruns, many have in the past not considered the potential impact on their finances (and hence their interest cover covenants) of potential falls in the value of land-banks or building work-in-progress. Historically many associations, and the regulator, viewed market rate developments and land-banking as virtual one-way bets, the profits from which could be used to develop incremental housing with less need for government grant. The GFC has helped to change these views.

3 PROJECT CASH FLOWS

There are various ways in which housing associations can acquire and develop affordable housing. The route taken will determine their risk profile and demand for finance. Although the delineations are not always clear cut, and some contracts will mix and match these approaches, the following are the main options:

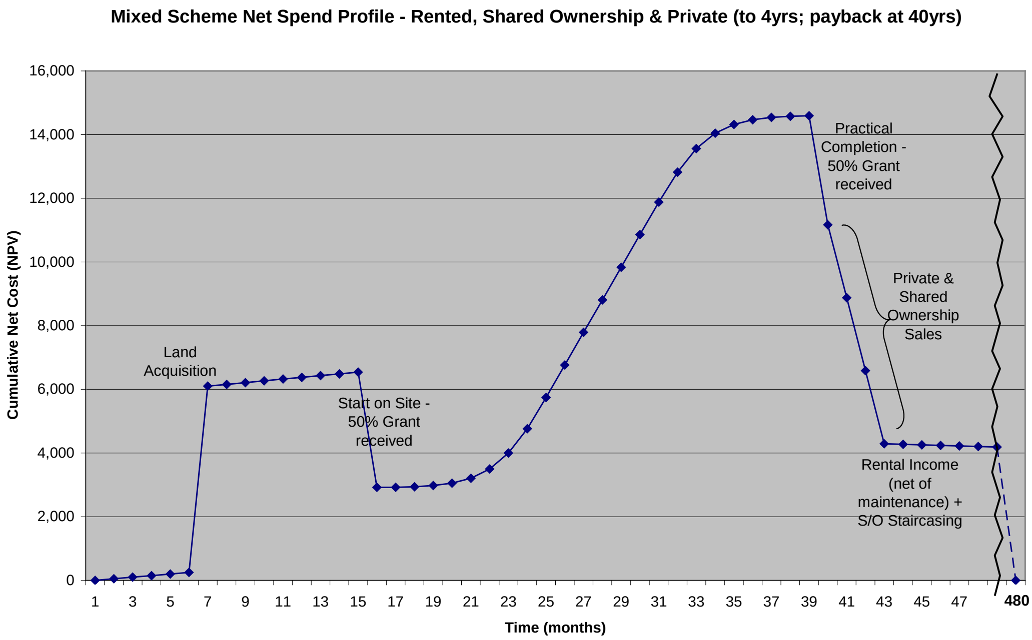
→ Start to finish development by the housing association, including sometimes the speculative acquisition of a land-bank (a portfolio of land held for development at some future date). This is the more complex scenario described below (Figure 6).

→ Development in conjunction with a private developer through the use of the planning incentives described in Section 2.4.

→ 'Off the shelf' purchase of housing from a developer, perhaps the most straightforward of these three broad routes.

The development and operation of new social housing generally takes place over a number of stages, which have specific implications for risk burden and cashflows of a housing association. As with private development, the steps outlined below will not always be sequential but may, at times, run in parallel (Golland & Blake 2004). An indication of cashflows for different development approaches is shown in Figure 6.

Figure 6: Project development costs

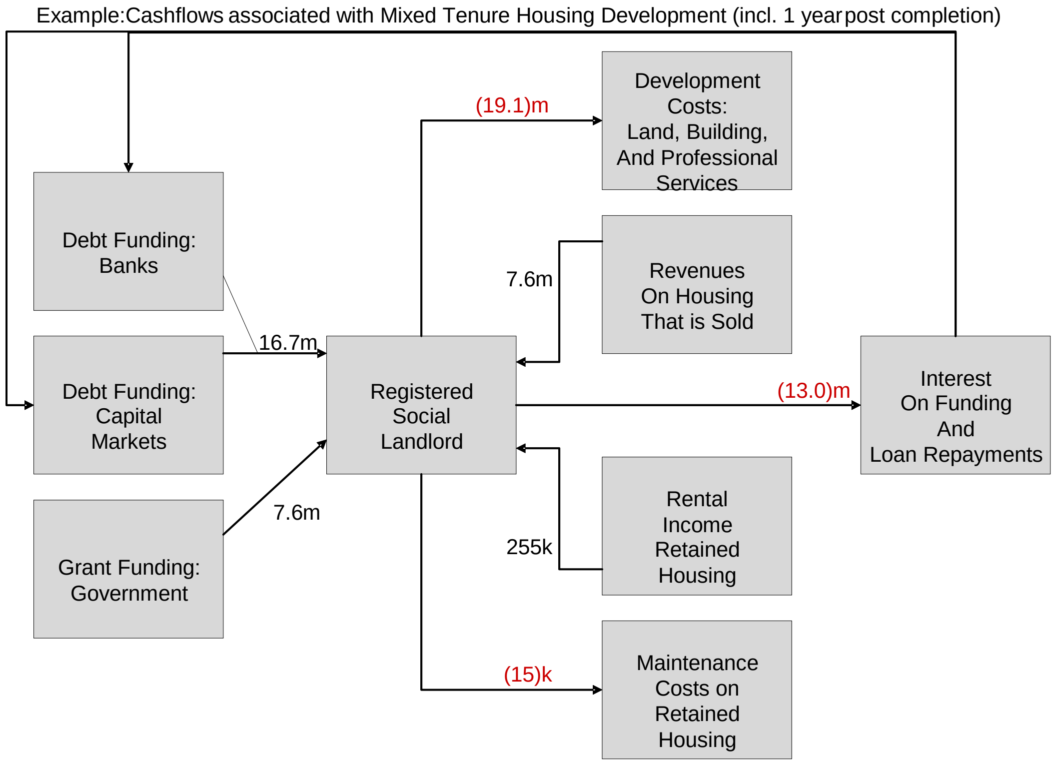


Source: Mark Washer, Affinity Sutton 2009

3.1 Cashflow calculations

Figure 7 shows typical cashflows associated with a scheme developed by an English housing association, including the development period and the first year after development. The loan drawdowns required by the association will depend on its overall cash position and may vary. The profile of the scheme will be invisible to the bank since loan arrangements are typically based on the banks assessment of the association's profile, and while it will usually want to be kept informed about large or unusual developments, typically through the annual loan review meeting, they will not require sight of standard affordable housing development data. The first year's cashflow gives some indication of the way in which more recent schemes generate losses in many cases, since the sum of all costs (including interest payment) exceed income. Over time, as interest payments (subject to certain fluctuations) stay broadly at the same level, income increases faster than inflation, leading to an improving cashflow position in the longer term. In the case of bond debt, this will be fully drawn when the bond transaction is completed at the start of the project.

Figure 7: Example project cashflows



Source: Mark Washer, Affinity Sutton 2009

3.2 Site acquisition, design and contracting

The first step in undertaking a development is to acquire the land where the development will be based, which can range from *greenfield* sites (e.g. farmland which the developer hopes to convert into a housing site) to *brownfield* development areas such as formed industrial sites. Greenfield site acquisition is unusual for English housing associations, though prior to the GFC associations were increasingly engaged in land-banking brownfield sites where appropriate planning still needed to be secured and where Social Housing Grant had not been allocated.

As there are many stages between site acquisition and eventual development, the money that is borrowed to fund land acquisition results in a cash drain for the developer. As land-banks are normally not funded by government grant, their purchase is generally debt financed by associations, which results in interest costs in carrying the land asset and reduction in the overall finances of the organisation.

Perhaps more importantly, the value of land will vary over time. If this volatility results in a reduction to land value below the purchase cost, the result could be an impairment, which would be reflected in the financial statements of the association. If the value of the impairment was large enough, this could put the association at risk of breaching funding covenants, described in Section 4.2 below. Covenant breaches can have serious repercussions, as this would generally make all of the association's funding immediately due, which would involve intervention by both the regulator and lenders. In the current uncertain financial climate, a re-negotiation of banking facilities would probably involve a substantial increase in borrowing margins.

Following land acquisition, detailed architectural plans for the site are developed, taking into consideration the local authority master plan and the desired mix and overall amount of housing type. Design and marketing considerations are important, along with input from the association's housing management team which manage the rental housing during the lifetime of the asset, and sustainability issues. While it is advisable to complete some of this planning and design work prior to acquisition, in order to gain a better understanding of what the site is worth based on a consideration of the likely costs and revenues associated with the proposed development, the post-acquisition design planning is much more detailed in order to support formal planning permission and the eventual build-out of the site.

There is no guarantee of success in the planning process, which means that the association can suffer a loss if overall planning is not achieved for the site or if the density of housing, which is closely tied to the revenues that the site can produce, is lower than expected. There could also be costly planning conditions attached to the site. The planning process can become quite lengthy if there is opposition to the development plans or if several iterations of the design are required by the council. As with site acquisition, the design and planning phases further drains the cash resources of the developing association and is most likely funded by debt. Moreover, due to the uncertain outcome of the planning process, the developing housing association is also exposed to financial risk if an undesirable outcome is achieved.

Following receipt of planning permission, builders and other contractors are formally appointed to construct the development. To protect against cost over-runs, it is typical to bid these contacts on a fixed price basis. Several standard forms of contract exist in England and these will typically be used for arrangements between housing associations and building contractors. In general, funds are advanced to builders in proportion to the amount of work completed. Despite this staggering of payments, the housing association bears some risk in the event of a builder's insolvency, as there are incremental costs associated with bringing in new builders part-way through a development. To help protect against these risks, it is common for developing housing associations to require that the builder provides a performance bond based on a percentage of the cost of the building works and maintain insolvency coverage.

The build phase places further strain on the cashflow of the developing housing association, with a consequent increase in interest costs. For the social housing units in the development that are benefitting from a government grant, approximately 60 per cent of the grant is received when building works begin, with the remainder paid at completion. To limit risk, large building sites are often divided into phases, with part of the site developed and sold prior to the commencement of the further phases.

3.3 Letting or sale

The completion of the development process usually results in a mix of shared ownership and social rented units, and sometimes private housing for sale on the open market. Depending on the tenure of the stock, it will either be handed over to the operations department of the housing association for allocation and letting, or will be marketed for sale. In the case of rented stock, the association will retain the stock and be responsible for all aspects of its management and maintenance over its life.

With rented stock, when a housing association has a new or empty property it needs to decide who is going to live in it. The options are:

- → Ask the relevant local authority for a nomination to the property. It is common for associations to have an agreement to give a certain percentage of their nominations on empty properties to the local authority. The percentage varies by region and type of property, though it is normally between 50 and 100 per cent of nominations. Councils use their own criteria to decide who should be offered the property, though in practice they always want more nominations than they get as they have the statutory duty to house residents. With single authority transfer LSVTs, councils normally agree to nominate households who work in the area.
- → Offer the property to someone on the association's waiting list using the ranked criteria that is set by their own nominations policy.
- → Place the property into a Choice Based Lettings system if one exists locally, with potential tenants allowed to bid. The local authority will give a priority rating to all applicants on the list, and allocation would be by priority and waiting time.

One of the issues is how local authorities decide what priority to give to residents as sometimes a local authority's banding system will be different to that of a housing association. Associations may also work across an area with a number of local authorities, each with subtly different policies. Whichever allocation system is used, there are stringent tests that applicants must meet to secure a housing association property, though many residents will not be employed and eligible to receive Housing Benefit. Table 8 shows the economic status of residents of different tenure types.

Table 8: Tenant economic status by tenure, 2009

	Owner occupiers	Social renters	Private renters
In full time work	58%	24%	60%
In part time work	9%	9%	10%
Unemployed	1%	6%	4%
Economically inactive	32%	60%	26%

Source: CLG 2009a

The increasingly narrow allocations process in England, which means that local authorities will often look to use their nominations rights to allocate 100 per cent homeless people to new properties, has implications for associations. As a consequence, it is increasingly common for associations to take on wider social and support roles in order to build stable tenancies and communities. In many cases, extra staff will be employed to support tenants with high social or personal needs.

3.4 Operation, maintenance and repairs

Once units have been completed, all expenditure on managing and maintaining those properties over the long term becomes the responsibility of the association. Those costs must be met from rental and service charge income, with access to any direct revenue subsidy usually only available to support the non-housing needs of some tenants. For example, the English Government's Supporting People program offers vulnerable people the opportunity to improve their quality of life by providing a stable environment which enables greater independence.

In addition, and reflecting the corporate model described in this report, associations must not only cover their own costs, but must also cover the costs of running a corporate entity and make sufficient surplus to provide for uncertain events. Associations' approaches to cost control, efficiency and cost reduction have increasingly been reviewed by the regulator who normally requires preparation of high level plans to deliver increasing efficiency through a variety of means:

- *Annual Efficiency Statement.* This was introduced in 2004, but its use was brought to an end four years later. It was a statement produced by an association which set out its assessment of its efficiency, provided a forecast of the upcoming year and what steps it would take to make efficiency savings, and looked backwards at the past year to assess performance against previous plans.
- *Operating Cost Index.* Also introduced in 2004, the Index establishes for all housing associations a predicted level of operating costs which can be compared against their actual cost performance. Data is published annually and associations ranked by their relative performance (Housing Corporation 2007a).

The current regulatory review retains the TSA's role in ensuring that associations pay sufficient attention to secure value for money for their residents (TSA 2009b). However, pressure to reduce costs can put pressure on quality. The regulatory emphasis is very much on efficiency and value for money, rather than a one-dimensional approach to reducing costs. In addition, there are robust quality standards against a range of key indicators that associations are expected to meet and look to improve on over time, so the pressure on costs does not operate in a vacuum. For example, associations must undertake and publish annual tenant surveys, and publish key maintenance indicators, such as speed of completing jobs.

Housing associations are responsible for the day-to-day and longer-term maintenance of their social rented units. How associations allocate their budgets across their range of responsibilities is a decision which is down to their management and boards. However, as a result of the Decent Homes Standard (see Section 5.2), the TSA monitor key indicators to ensure that a 'decent' standard is achieved.

One consequence of the regulation of rents is that there is no scope to increase rents to pay for major works, such as providing new roofs or windows, or offering enhanced facilities—for example, new kitchens and bathrooms. For any rent increase to be applied there must be an increase in the value of the property, and the formula for establishing rents does not result in an increase that approaches the cost of the work undertaken. One interviewee for this report commented that £5000 ($9000) spent on installing central heating would probably result in additional rent of less than £100 ($180) per annum. As a result, associations need to work on the basis that they must meet the cost of major repairs and improvements from their own resources.

4 ASSET AND REVENUE SUPPORT

Despite the use of asset backing and strong revenues to support private finance for English housing associations, it is important to recognise the role of regulation in providing considerable comfort to lenders and investors that they will get repaid.

4.1 Role of regulation

Housing associations are regulated by the TSA, a government agency. The level of the regulator's scrutiny and its step-in powers are heavily relied upon by lenders in their willingness to make available funding to associations at relatively low margins. The TSA's approach compared to the Housing Corporation has yet to take shape, though the regulator has indicated a commitment to a more flexible regime and one where the regulated bodies take greater responsibility for their own performance (TSA 2009b). Two fundamental protections for private lenders are likely to remain:

- The TSA will continue to have a clear brief to assess the financial viability of individual associations and publish the results.
- In common with the Housing Corporation, the TSA retains robust powers to step in to a failing housing association to deal with serious problems. Ultimately it can appoint non-executive directors and direct the association to take certain courses of action including merger with a stronger housing association.

While the UK Government does not formally underwrite housing associations, both of these provisions have helped to create an environment where private investors and lenders gain comfort that associations will not be allowed to fail. In practice there have been few occasions when this theory has been put to the test:

- Late in 2007 a London housing association, Ujima, was put under Housing Corporation 'supervision' as a result of financial difficulties and the prospect that it might breach funders' covenants (Cooper 2007). The regulator worked with Ujima's funders to find a solution short of the funders using their contractual powers to call a loan default, potentially stepping in to take possession of the charged properties. In the event, Ujima merged with L&Q, a large and financially robust London-based association. The transition was achieved in less than six weeks and no creditor lost money as a result of the association's failure.
- As a result of the GFC, with turmoil in financial markets and UK property values falling, there were serious concerns that a number of associations would make losses that would cause them to breach lenders' covenants. Where associations held assets valued against the market (such as land-banks and properties for sale), the fall in property values would need to be reflected in their accounts. In order to avoid this risk, the TSA worked with the HCA to provide additional grant to some associations to enable them to change the tenure of some stock from sale (which is exposed to market value reductions) to social rent (which is not).

Interviewees questioned implications that may follow from the UK bail-out of certain English housing associations by the regulator during the GFC. Recipient associations are considered by a number in the sector to be those who acted less prudently, in particular those that relied to a greater extent on market sales and shared ownership. The relatively light negative consequences for failing housing associations could create a 'moral hazard', encouraging further imprudent behaviour in the future. Associations that had acted carefully, by minimising risk, may feel that they have not been rewarded as funding has been channelled to the weaker members of the sector. Several commentators now view the sector as too important to fail and the government could not afford the political risk if a large association closed.

4.2 Key loan terms

Commercial loan agreements to housing associations contain contractual arrangements which protect lenders. For example, nearly all bank and bond funding raised by housing associations is secured by social housing assets. This ensures that there is a legally valid title to the property, that the title is not being used as collateral for any other borrowing, and that the title is capable of being charged as security. The process also seeks to identify any complications, such as restrictive covenants, which might make a property unsuitable for loan collateral. The security process is completed after regulatory approval has been given, the funder is satisfied with the value of the security, and a legal charge is put in place in favour of the lender.

As housing association rents are set at sub-market levels and subject to other regulatory constraints, such as limits on the amount by which rents can be increased, social housing assets are often valued on an ‘existing use’ basis. This is normally significantly lower than the value that could be achieved if the property were sold on the open market without restrictions, though the value is more stable and not subject to the same volatility. The value obtained through the ‘existing use’ method is based on the discounted value of the regulated rental streams less anticipated operating costs, including major works and repair costs. When housing assets are used to support association borrowing, there normally are requirements to have at least £1.05 of property valued on an existing use basis to support every £1.00 of borrowing.

Housing association loan agreements generally impose constraints and obligations (also known as *covenants*) on the borrower. These covenants are generally broken down into two categories: positive covenants (which stipulate things the housing association needs to do), and negative covenants (which stipulate things that the housing association cannot do). Examples of covenants on associations include:

- Ensuring that sufficient assets are charged to the funder and that property valuations are completed on a yearly basis.
- Producing sufficient cashflow in relation to interest expense on a yearly basis—often known as the interest cover covenant.
- Producing audited financial statements in a timely fashion following the year-end, and providing funders with management accounts and business plans.
- Making scheduled interest and principal payments when due.
- Obtaining the consent of the lenders for any mergers or material disposals.
- Complying with regulatory obligations.

If a housing association cannot meet its covenants, it is generally given a short grace period in which to rectify the breach. If the covenant breach cannot be rectified, or if the funder will not waive the covenant, the funder has the right to demand immediate repayment of the loan. If this does not take place, the lender has the right to enforce its security over the charged properties, take possession, and sell them at an open market value. In practice, however, there has not been a lender enforcement action of this severity in England, due to various housing regulator intervention powers.

The covenants attached to loans to LSVT housing associations tend to be more restrictive and are likely to include, for the first several years, a requirement for the lender to give its approval annually to a financial plan. Bond covenants tend to be looser for the borrower than covenants in a commercial loan agreement, recognising the more arms-length relationship between association and bondholder.

4.3 Sector financial profile

Table 9 provides a financial summary of the whole sector's income and expenditure account as at 31 March for the last three years for which consolidated data is available. The format of housing association accounts is broadly the same as that of commercial companies, though it is governed by a dedicated Statement of Recommended Practice. Annual statutory accounts are audited by appropriately qualified firms of accountants in the same way as commercial companies.

Table 9: Housing association global accounts—P&L and ratios

	2006	2007	2008
Turnover (£m)	8,334	9,117	10,093
Operating cost and cost of sales (£m)	7,055	7,685	8,508
Operating surplus (£m)	1,268	1,417	1,575
Surplus on social housing lettings (£m)	1,262	1,397	1,545
Net interest payable (£m)	1,476	1,596	1,765
Profit on sale of assets (£m)	499	542	577
Surplus for the year (£m)	241	257	319
Ratios			
Operating margin	15.2%	15.5%	15.6%
Interest cover	105.8%	106.9%	105.2%
Debt per home (£)	13,685	14,111	15,013
Management cost per unit (£)	730	780	844
Maintenance cost per unit (£)	863	878	901

Source: TSA 2009c, p.15 —data includes associations with over 1,000 properties. Year to 31 March

Sector turnover, at just over £10 billion ($18 billion) comprises largely rental income from affordable properties held on the balance sheet. Other sources of income include service charges levied, largely on multi-occupancy properties, to recover the cost of communal services such as grounds maintenance or lighting to common parts. There are also grants paid by local authorities for a range of support services, income from non-social housing lettings, such as student accommodation or properties let at market rents. Some associations receive income from property sales, either on the open market, or on a shared ownership basis.

Table 10: Housing association global accounts—balance sheets

	2006	2007	2008
Net book value of housing (£bn)	40.1	44.0	48.8
Current assets	41.8	45.9	51.0
Current liabilities	3.1	3.5	5.3
Total assets less current liabilities	42.7	47.2	52.4
Financed by			
Long term loans	27.8	30.4	34.2
Revenue reserves	3.6	4.0	4.6
Long term creditors	1.6	2.4	3.0
Other reserves	9.7	10.4	10.6

Source: TSA 2009c

One of the principal obligations of an association is to pay its lenders' interest when it falls due. Any default can lead to severe consequences for the association since a breach of loan terms can result in detrimental revisions to the terms of those loans, and, at a sector level, could result in damage to the sector's reputation among lenders. Interest cover is a measure of the amount of operating surplus available to fund interest divided by the amount of interest paid, and is typically set at 1.05 (and never below 1.0). The 2008 figure shown in Table 9 is 1.052, which provides very little headroom for adverse movements in the revenue position.

The balance sheet information in Table 10 shows the capital position of the sector, and how assets are funded. Housing assets grew significantly over the three years to March 2008, from £40 billion ($72 billion) to £48.8 billion ($88 billion). This was financed by increases in loans over the same period of £6.4 billion ($11.5 billion), demonstrating that the sector is increasing leverage (the ratio of debt to equity, also known as gearing) over time. This is confirmed by the increase in debt per housing unit from £13 685 ($24 633) in 2006 rising to £15 013 ($27 023) by 2008.

The data in the sector's global accounts are based on audited results of individual associations. Analysis of March 2008 data indicates that the profile of LSVT housing associations can be very different from the more traditional older part of the sector (Cowley 2009). LSVT associations are often more than 100 per cent leveraged to fund the stock purchase from the local authority, and will usually make deficits for a number of years after transfer. Their loan agreement with funders reflects this, and covenants will be set accordingly. LSVT associations are often required to seek their funders' approval to an annual update of their business plans, and other detailed requirements that give the bank quite close control over their activities.

4.4 Rental setting and tenant income support

Rents on new stock have for nearly a decade been set by reference to a regulatory formula. This formula differentiates on the basis of size and type of property, and links social rents in a locality to both local average earnings and property prices (weighted 70:30 respectively). Thus, rents across England differ markedly although, as shown in Table 11, remain materially below market rent levels on average. The exceptions are in low housing demand areas, often in the north of England, where market rents can be lower than the 'target' regulated social housing rent. In areas of high demand, particularly in London and the south east, social rents can be as low as 40 per cent of market rents. As well as rents on new tenancies, associations are required to bring rents for existing tenants into line with the target rent over time. All rents are required to be at target levels by 2012, plus or minus 5 per cent.

Annual changes to rents are linked to the Retail Price Index (RPI) measure of inflation, and increase (or decrease) annually by RPI plus 0.5 per cent based on the September RPI data. Table 11 shows rents across different landlord types, confirming a significant differential in costs between the private and social sectors.

Table 11: Weekly rents by housing provider type

	2006–07	2007–08	Change
Private rented—all tenancies	123	129	+4.6%
Private rented—assured tenancies	130	134	+ 3.1%
Housing association	67	70	+5.1%
Local authority rented	58	62	+6.0%

Source: CLG 2009a—figures in £ per week

While target rents are designed to meet certain affordability criteria and are, in the main, materially lower than comparable market rents, they are not affordable to all tenants from their own resources. As a consequence, the welfare system provides additional means-tested support to individual tenants. The use of welfare payments in the UK to low-income households to make rent affordable dates from 1919, although it was reformed in 1982 with the introduction of the *housing benefit*. Central to benefit calculation is an assessment of eligible rent and ineligible services as housing benefit will only meet the pure rent costs of any liability. Ineligible services are the parts of the claimants' rent liability that they must meet themselves, including the cost of heating, lighting, water rates, meals and any general counselling and support that may be included in the rent charged but will not be subsidised by housing benefit.

This tenant income support system is a form of public subsidy that covers approximately two-thirds of the housing association rental income. While associations can therefore be confident that two-thirds of their rental income is secure, the process can be bureaucratic and delays can occur as local authorities process claimants' applications. At present the housing benefit, which is a personal benefit targeted to individuals, is paid directly to associations, though not to commercial/private landlords. This provides very considerable comfort to associations and their funders alike, since it results in minimal levels of bad debts and keeps arrears to a minimum. However, there has been a policy debate in the UK for several years over whether the payment should be made directly to the tenants. This has been resisted by the sector.

5 ASSET MANAGEMENT STRATEGIES

The balance of ensuring financial continuity and achieving social mission is a challenge for the housing association sector. Unlike private businesses, associations do not set primary financial targets, yet they need to maintain the finances in a healthy position and re-invest in their assets to maintain long term success.

5.1 Financial planning and appraisal

Associations are long term developers and managers of their housing stock. The stock is owned by them, forms part of their balance sheet and, against a tight regulatory backdrop, is theirs to manage as they see fit. This calls for detailed and robust financial planning, a skill expected by both regulator and funders.

Typically associations produce long term financial plans, over 30 years, to show they are capable of repaying their long term private finance and maintaining their assets when major improvements may be required. As the sector has matured, there is a move to less of a focus on 30-year plans from lenders, though the TSA still requires the submission of a 30-year plan. However, the TSA has indicated as part of its review of regulation that the time horizon of these plans will be significantly reduced. If this happens, it will reflect the reality that it is impossible to accurately forecast in the long term and that potential problems are more likely to be short term.

A critical financial control for housing associations is that they undertake effective investment appraisal before committing to new developments. Associations are free to adopt whatever methodology they wish. Whichever approach is used, and most involve discounted cashflow and net present value, there are challenges as Social Housing Grants are low, land prices high, and many projects are only marginally cash positive, or even cash negative. This is demonstrated by the average value of commercial loan per property, which is on an upward trend (see Table 9). The surpluses that the sector needs to generate to deal with risk, unplanned costs and to keep it attractive to lenders, come from older stock developed with lower levels of private finance and consequently little or no interest cost associated with them.

5.2 Repairs and improvements

Once completed, housing assets will be in the ownership of an association for several decades. Responsibility for repairs remains with them and there is little or no scope for public grants to cover major works costs. There is also no opportunity to increase rents under the target rent arrangements, and so this means that associations must plan for replacement of components as they come to the end of their useful life. This can create challenges for associations, many of whose margins are low. Some respond to this by disposing of assets to meet part of the cost, with others using private finance to invest in existing stock. This latter approach leads to a further tightening of surpluses as interest costs increase with no corresponding rise in rent.

However, they seek to fund repair costs, most associations generate detailed plans for stock investment. As with new development, and depending on the state of the stock and the level of provision, this often gives funders comfort that part of the cost reflected in the association's planning is essentially discretionary and that, in the event of financial difficulty, major works can be deferred to allow a period of recovery.

In addition to maintaining stock in good condition through a program of major repairs, over time housing approaches the end of its useful life or it ceases to be attractive to residents. For example, bedsits or studio flats were once easy to let, but are now seen as an inferior product and are hard to let, and central heating systems are expected as a minimum. Associations will incorporate plans for these types of work, but cost pressures can cause strains. One way that associations have raised funds for stock replacement is to demolish and redevelop estates, often creating more homes on the same site of which some will be sold on the open market to generate a cross subsidy.

In recognition of the poor state of some affordable housing in the UK, in 2001 the Government introduced the Decent Homes Standard (DETR 2000). This sought to create a minimum quality standard for social housing in both local authority and housing association ownership. It was estimated in 2001 that around 1.7 million social rented sector dwellings in England, or 41 per cent of the total, were 'non-decent' on this measure (ODPM 2002). The government's expectation, probably unrealistic, is that all stock will comply with the standard by 2010.

The Decent Homes Standard has focused asset management strategies on achieving the standard, and where the gap in compliance is large this has proved problematic for some landlords. The standard has put pressure on landlord costs that must still be covered by regulated (and capped) rents. Where associations have been unable to afford the costs of Decent Homes through normal cashflows, asset disposal has been used to generate surpluses to meet some of the cost. In some cases, waivers have been given to associations to allow them more time to comply with rent regulation.

5.3 Asset disposal

Disposals have become a feature of the asset management strategies of some housing associations. The TSA must give consent for disposals of assets that have been grant funded, known as *Section 9 consent*. The regulator's willingness to give approval has fluctuated over time, but it is common for approval to be granted. Asset disposals by associations may take place for one of several possible reasons:

→ As the result of approaching the end of its useful life.

→ Where the stock lies outside an association's strategic boundaries, or in an area of a region where it is not economically rational to retain it.

→ Where an association needs to generate surpluses to invest in retained stock.

→ Where financial difficulties require a cash injection and/or a reduction in the quantity of loss making stock. Note that this is not a common reason.

Disposals can either be to other housing associations or on the open market. Disposal to another association is the only permitted approach where the stock is occupied by social housing tenants. Even in these cases, it is not unusual for associations to market the stock to other associations so as to achieve the best price. Typically, other associations are invited to bid for the portfolio of stock, and the winning bid is likely to be the highest. However, best practice suggests that the vendor should also pay attention to the views of existing residents. Where vacant property is sold, the association is likely to adopt the route likely to achieve the best financial return.

6 INVESTOR YIELDS

Housing associations' relationships with their lenders operate on a commercial basis. Associations are free to determine how much they will borrow, from whom, what form that funding will take and how much they will pay. While the regulator will take a view on key elements of an association's treasury management arrangements as part of their assessment of financial viability, the regulatory provisions focus on ensuring a controlled approach to treasury risk management commensurate with risks.

6.1 Commercial lenders

The *Housing Act* 1988 created a highly competitive market for lending to housing associations by banks and building societies until the GFC in 2008. Building societies are regulated mutual institutions established to write mortgages financed by retail deposits, though many building societies de-mutualised during the 1990s to become Stock Exchange listed banks. Loans to housing associations have been used to fund stock transfers, catch up with repairs, and fund core association business activities.

The structure of costs charged by commercial lending typically incorporates:

- *LIBOR.* The London Interbank Offered Rate is a daily reference interest rate based on the rates that banks borrow unsecured funds from other banks in the London wholesale money market. Three-month LIBOR is the prevailing reference interest rate for most housing association bank debt, although in a minority of cases the Bank of England Base Rate is used.
- *Margin.* The margin is the premium over LIBOR charged by the bank to reflect the risks of lending and to cover overheads. Margins are usually measured in *basis points* (bps), or hundredths of 1 per cent. For example, 110 bps is equivalent to 1.1 per cent. LIBOR and the margin are charged on outstanding loans.
- *Non-utilisation fees* or commitment commission. These are the ongoing fee charged by lenders on undrawn elements of a loan facility to reflect capital costs.
- *Arrangement fees.* Typically commercial lenders charge a one-off up-front fee when a new loan is arranged, or a loan re-financed.

The 'all-in' price of funding for lending to a housing association is made up of margin, non-utilisation fees and arrangements fees. Most loan agreements are based on a default interest rate which is variable (based on LIBOR which moves with the market), but normally incorporate provisions for the borrower to opt to fix interest rates to manage interest rate risk and obtain some certainty as to their interest cash flows.

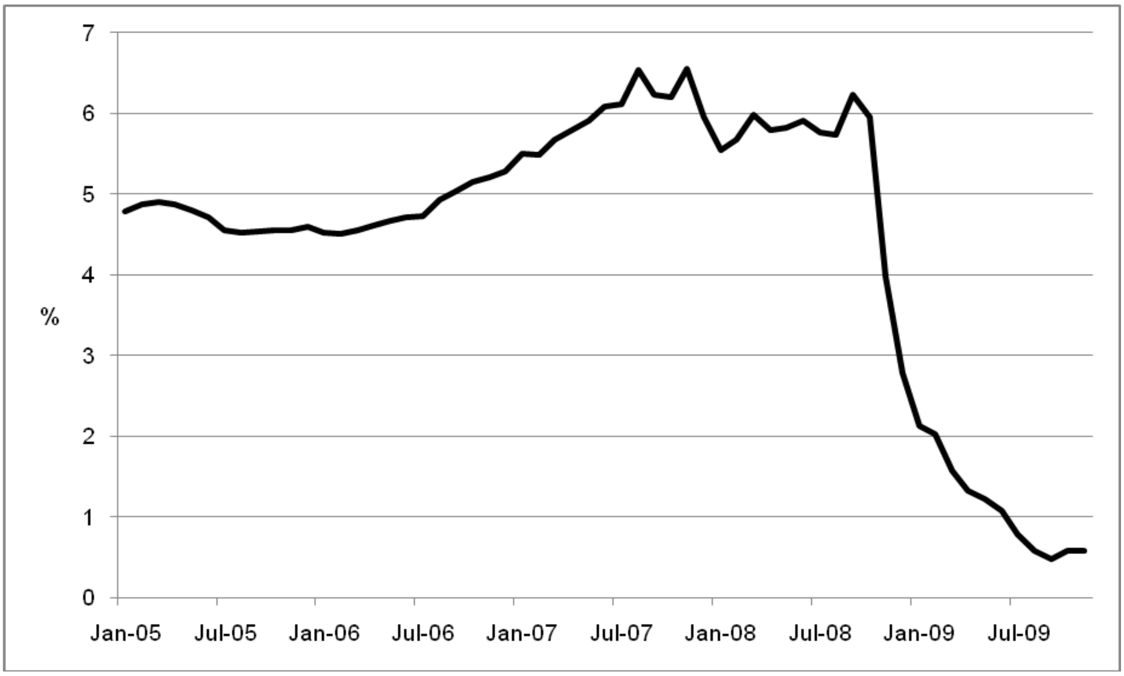
The all-in cost of borrowing for housing associations declined significantly from 1988–2008. This was driven by the appetite of a limited number of UK lending institutions to lend to the sector, which in turn reflected the view of lenders that, while there might be better returns to be made in other sectors, there were few sectors with such a low risk profile. This was reinforced by the good performance of early loans to the associations, a robust regulatory structure, and the absence of defaults.

In the period after 1988, commercial lenders became comfortable with a sector that they knew nothing about before. A characteristic of commercial lending to English housing associations is that there has been only limited differentiation between weaker and stronger associations in terms of debt pricing. Consequently, an association with a strong balance sheet and track record could expect pricing broadly on a par with a riskier, less financially robust organisation.

In the early 1990s, margins were typically offered to associations at between 150 and 200 bps. Immediately prior to the credit crunch many associations could borrow at around 25 bps, in some cases as low as 20 bps. It became common for associations to re-finance their debt several times to improve pricing. This competitive pricing by UK commercial lenders resulted in capital markets playing a minimal role in funding associations in the decade to 2008 as bank debt was cheaper than bond finance.

The GFC has fundamentally changed the relative costs of these two sources of finance. The banks' need to rebuild their balance sheets by increasing capital, and their tight liquidity position led to a period of several months during 2008 when several of the sector's principal lenders declined to make new loans. This was followed by a period when considerably higher margins are being charged on new and re-negotiated loans. In addition, interviewees noted that arrangement and non-utilisations fees have increased, and terms and conditions moved to being less favourable for associations. The Royal Bank of Scotland revealed in November 2008 that their margins on housing association lending had risen from around 30 bps before the GFC to over 150 bps in 2008 (Dowler 2008). Interviewees during November 2009 confirmed margin increases, citing 200 bps as a typical rate. Despite the margin rise, all-in rates have fallen as there has been a significant reduction in LIBOR as the Government attempted to stimulate the economy, shown in Figure 8.

Figure 8: Three month LIBOR, January 2005–November 2009



Source: Bank of England 2009—chart compiled by authors based on raw data

The GFC has changed the dynamics of competition in the commercial loan market. Competition for housing association business has reduced, and is now dominated by the traditional high street banks with several building societies having been squeezed out. Several banks have struggled during the GFC. Lloyds HBOS have a large share of sector lending, though have financial problems and are reducing lending. Nationwide building society has continued as a lender to associations, though has been distracted by the regulator persuading it to bail-out a number of failing smaller societies. The Royal Bank of Scotland is facing serious problems which will probably result in the organisation being broken-up. However, it is still lending to associations, in part due to the insistence of its majority shareholder—the UK Government.

6.2 Capital markets

Housing associations pursuing debt finance from bond markets are typically seeking longer term funding of up to 30 years in order to match the long duration of their underlying housing assets and to minimise re-financing risk. Association bonds have historically been issued at fixed interest rates, enabling borrowers to lock in the majority of their interest costs and avoid interest rate volatility. Bonds issued by the housing association sector typically carry a high credit rating (typically AA), and are mainly purchased by UK pension funds and insurance companies seeking predictable, low-risk and long-term assets to match their long run liabilities.

In the UK, there are no pre-set yields that bond investors can receive through their provision of debt finance to associations. Instead, bond investors seek a yield based on prevailing market forces when the bond is issued based on two components:

- The *risk free* rate, which is the market rate for a similar duration UK government bond, which would be rated AAA.
- The *risk premium*, which is the incremental margin above and beyond the *risk free* rate that investors require to hold the debt.

Table 5 shows the 27 housing association bond issues larger than £100 million ($180 million) in the market. The yield achieved by investors ranges from 11 per cent for a bond issued in 1992 to just under 5 per cent (for a bond issued in 2005).

The highest risk premium required by investors for housing association bonds occurred during 2008–09 at the height of the GFC. During this period, the most expensive housing association transaction resulted in a risk premium of 285 bps above an equivalent duration ‘risk free’ government bond. From a pre-credit crunch perspective, the highest risk premiums of roughly 200 bps were achieved on the earliest housing association bonds, with risk premiums tightening to a minimum of 60 bps for a 20-year bond issued to an association in 2005 (Social Housing 2009b). Recent bond issues, shown in Table 5, indicate margins of around 200 bps which confirm a near-parity of costs been bonds and commercial loan facilities.

7 ANALYSIS AND CONCLUSIONS

This report has used desk research and a limited number of practitioner and housing researcher interviews to review issues surrounding the introduction of private finance in England. Although the limited resources available for the research make definitive conclusions hard, particularly in reflecting on the applicability of English approaches to Australia, useful opinions have been gathered on the financial impact of the GFC.

7.1 Housing and finance outcomes

The introduction of private finance into social housing from 1989 provided the opportunity to reduce subsidy per dwelling unit (which had been running at over 90% in some cases) as government funding laws able to lever in private finance as well as housing association contributions from reserves. For new building, this replaced the traditional local authority approach of cross subsidy over time. It also provided an incentive for associations to reorganise their balance sheets and financial management to meet the challenge of mixed funding. Three important elements within the 1988 *Housing Act* financial framework that made this possible were:

- → The new freedom for associations to set their own sub-market rents to cover costs as well as to build up their reserves so they could raise private finance more cheaply and ultimately provide some form of internal cross subsidy.
- → The continued government commitment to the provision of Housing Benefit to cover actual rents in the social sector for those on the lowest incomes.
- → The role of the Housing Corporation in both regulating the sector and providing investment funding—with the associated capacity to force reorganisation, transfers and mergers where necessary, rather than a formal guarantee as, for example, in the Netherlands—provided comfort for financial institutions and helped the funders to understand the low risk nature of social housing investment.

As a result, housing association rents rose rapidly in the early 1990s. However, as the net benefits of rent rises to government declined because of increased Housing Benefit payments, they introduced rent controls first based on retail price rises (RPI) +1 per cent and then RPI + 0.5 per cent. This required associations to make some efficiency savings, particularly as labour costs rise in real terms. Even so, housing association rents have risen much in line with private rents.

Over the same period the proportion of association tenants in receipt of Housing Benefit rose from 53 per cent in 1991 to 67 per cent in 2006. This reflects the increased emphasis on housing those in priority need. But it also shows that housing association revenues are overwhelmingly dependent on income support. Were the terms on which Housing Benefit is provided to tighten, there would be a major impact on housing association financial viability and the price of funds.

Where the new framework was most effective was in reducing the cost of private funds. In the earliest years the cost of funds included a large risk premium, but this fell rapidly as the market became more knowledgeable and competition increased. Over a ten-year period, the risk premium reduced charged by banks declined to a level comparable to the fully Government-guaranteed market in the Netherlands.

This cost reduction was partly an outcome of the massive reorganisation of the sector including a growing capacity for sophisticated financial management—which may in some cases have gone rather too far for what is basically a fairly straightforward product. This has been reflected in some need for TSA intervention during the GFC, although all such problems have been managed effectively. At the present time, funding is more difficult and the number of financial institutions in the market has declined, though there seems no reason for longer term concern.

The second question is whether the introduction of private finance has enabled more total investment in English social housing. There are three possibilities as listed below.

7.1.1 Substitution

Has private finance been substituted for government funds rather than enabling increased total investment? Gross social housing investment in England (in real terms) fell by nearly one third in 1990–91 and thereafter fell by not far short of 45 per cent of 1991 levels between 1993–94 and 1999–2000. In the new century, it rose again and nearly reached 1990–91 levels again—but the initial one third has not been replaced. Association gross investment expenditure, on the other hand, increased somewhat until 1996 but then fell even in money terms until the new century. Thereafter, the cutbacks have been significantly reversed but levels are still below those of the early 1990s. Within this total expenditure, private finance has provided the majority of the funding from the mid-1990s to the turn of the century. Thereafter until the financial crisis private finance ran between 40–50 per cent of the total.

Thus, private finance has substituted for public funding, particularly through the massive decline in allocations to local authorities (which has somewhat been reversed through the Decent Homes program to bring existing stock up to standard). Even within the RSL sector, direct public funding together with private finance has not been enough to expand the program. However, in addition, there has been a stream of implicit funding from S106 agreements to provide affordable housing, which often involves free or discounted land and sometimes dwellings. Whatever, the economic cycle continues to impact on investment generating significant year to year variations.

7.1.2 Cost inflation

Has the new regime been associated with higher costs per unit of development? The main evidence comes from analyses of s.106 (inclusionary zoning) outcomes. These suggest that the biggest effect has been on changing the location of new development through the linkages to market development. Investment has shifted from lower cost to higher cost, more pressured, regions increasing costs per unit. At the same time development has moved away from single tenure sites—which were themselves often discounted—to mixed tenure sites, as well as from greenfield to brownfield. All of these shifts are policy led and in line with broader government objectives—but they all add to the costs of provision. The result is that grant rates, rather than falling, have stabilised around the 50 per cent mark, even though s.106 contributions have risen rapidly in the 21st century, at least up to 2007. The impact of the downturn in land values have yet to feed through fully—but currently grant rates have risen again to very high levels to help maintain output.

There has been a big change in the mix of development linked to the introduction of private finance and s.106 as both target numbers and the mixed communities agenda has made intermediate housing more attractive. It has the benefits of recycling funding quite rapidly as purchasers use traditional mortgages to fund their proportion of the dwelling price and then perhaps to staircase out. Associations have been able to use these funds, both to build more shared ownership properties and to cross subsidise social rented development. However, it has also left some associations vulnerable when the market turned down from 2007. Overall, the result has been a massive increase in the proportion of shared ownership dwellings on new s.106 developments since 2000, especially in the South East (see Table 12).

Table 12: Changing proportions of s.106 affordable housing completions

Tenure	Rent			Shared ownership			Other tenures (1)		
Year	2001-02	2005-06	2007-08	2001-02	2005-06	2007-08	2001-02	2005-06	2007-08
North East	83	73	80	13	24	17	4	3	3
North West	63	46	29	11	37	49	26	17	22
Yorks/Humber	88	63	54	9	24	39	3	13	7
East Midlands	59	54	50	13	40	43	28	6	7
West Midlands	69	50	49	6	34	41	25	16	10
East	90	65	64	5	27	33	5	8	3
London	75	68	63	20	29	37	5	3	<1
South East	78	57	57	20	35	41	2	8	2
South West	82	60	55	9	35	34	9	5	11
England	77	60	57	13	33	38	10	7	5

Source: Christine Whitehead based on HSSA statistics from CLG. Other tenures include discounted market sale units (up to 2007–080), local authority units, and units of unknown tenure

7.1.3 Higher Output

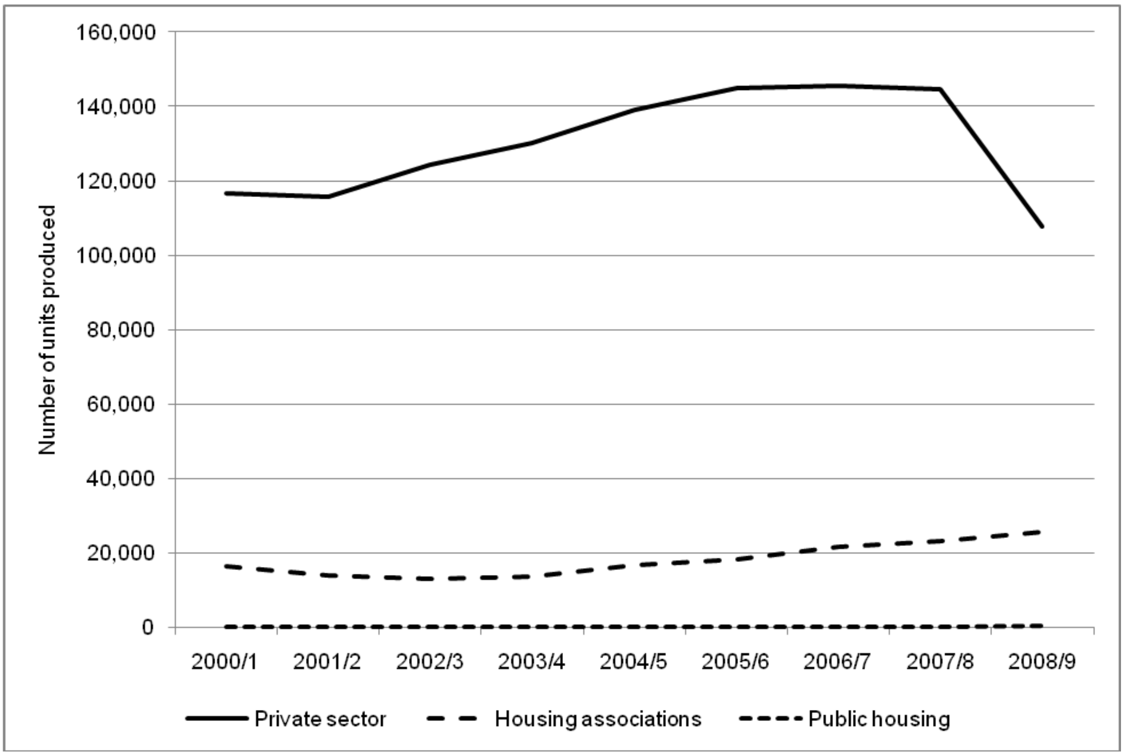
Has the private finance system led to a higher output of affordable production? Table 13 shows the trends in completions in the social sector since 1991. It confirms that housing association completions have only partially been able to compensate for the massive reductions in local authority output. It also shows much lower levels of output in the ten years after 1997. Over the last few years housing association output increased as a result of increased subsidy as well as private finance, as shown in Figure 9, though this growth has now been curtailed by the GFC.

Table 13: Changes to English dwelling stock in 000s, 1992–2007

	Housing associations	Local authorities	Net Reduction
1992	+38	-55	-17
1993	+68	-84	-16
1994	+65	-94	-29
1995	+78	-101	-23
1996	+85	-95	-10
1997	+43	-69	-26
1998	+65	-92	-27
1999	+106	-131	-25
2000	+127	-166	-39
2001	+151	-200	-49
2002	+68	-106	-38
2003	+159	-243	-94
2004	+51	-122	-71
2005	+100	-169	-69
2006	+40	-80	-40
2007	+44	-99	-55

Source: Christine Whitehead—based on CLG Live Tables, 104

Figure 9: English dwellings constructed across tenures, 2000–01 to 2008–09



Source: CLG 2009c

The increase in housing association stock has never been enough to offset the decline in local authority housing, and indeed this growth has been to a large extent the result of transfers from the local authority sector. This is hardly surprising as the Right to Buy has led to a reduction in the size of the British social housing stock by one third over 25 years.

Without the private finance changes introduced in 1988 and the impact of developer contributions through s.106, the social rented sector would undoubtedly have declined considerably further and faster. But this has been at the cost of considerable additional complexity and risk. The partnerships between public and private finance and development have both been highly successful in their own terms—but the broader policy and economic environment has meant that it has not been possible to increase their net contribution to affordable housing requirements.

Despite the UK facing severe dislocation in property and financial markets over the past two years, private finance has remained available to associations, albeit with higher risk premiums charged by lenders. The regulator has recently reported that 'access to private finance remains good for the sector, with Finance Directors reporting positive discussions with lenders' (TSA 2009e, p.1), although demand for new loans has been significantly lower than in the previous year. There is evidence of rising optimism in the sector and 92 per cent of housing associations forecast debt requirement for the 12 months from October 2009 are already in place (TSA 2009e).

7.2 System limitations

The English private finance system for housing associations has evolved considerably since 1988, through changes in legislation, public funding and financial innovation by the market. These transitions have not always been smooth, for example, recent changes to housing legislation were strongly contested by the National Housing Federation who feared associations' independence was being undermined. Continuation of commercial lending during the GFC was underpinned by strong expressions of government support, and additional funding to ensure new housing development projects continued. Therefore, the 'private' finance system remained dependent on public regulation, funding and leadership.

In parallel to the increasing debt levels of housing association since 1988 has been a reduction in the Social Housing Grant. Though this is an expected corollary of introducing private finance, several interviewees considered that grants had been reduced too low. Furthermore, the decline in grants coincided with a period when associations have become expected to provide additional social and community services. To meet the financing gap, in particular to meet growing interest bills, associations have engaged in a number of commercial activities. Their involvement in market rate sales, shared ownership and land-banking expose them to a new range of risks and led to the employment of expensive, technically qualified staff. This has moved associations, particularly the larger groups, somewhat away from their traditional social mission.

The importance of asset sales is shown from the global accounts in Table 9. In the year to March 2008, the sector made a surplus of £319 million ($574 million), but this was after including surpluses on asset disposals of £577 million ($1.04 billion). In all three years from 2006–08, without asset sales the sector would have made a loss. The full impact of the GFC will be evident in the 2009 accounts, when asset sales are likely to be modest and the sector may fall into deficit. As a consequence, loan covenants may be breached by individual associations leading to a re-financing risk for commercial loans. New facilities are likely to be provided at higher cost, further increasing associations' cost base. In the absence of higher levels of Social Housing Grant, associations may be forced to further expand commercial activities.

7.3 Lessons from English approaches

Characteristics that are specific to England, for example, a relatively large social housing sector, high capacity housing associations, strong national regulation and a sophisticated, innovative finance sector, are arguably not present in Australia. While UK institutional investors have shown an appetite for investment in housing association loans and bonds, Australian investor appetite is uncertain, markets less liquid, and understanding of the association sector less developed (Gilmour & Milligan 2009). Furthermore, the generous support for tenant incomes through housing benefit, paid direct to English housing associations, is not matched by Australian Commonwealth Rent Assistance. Demand-side support of tenant income has been a fundamental underpinning of private finance in England.

Despite these national differences, experience from England highlights several benefits brought by private finance. For example, the new approaches have helped drive the professionalisation of the sector—of housing associations, regulators and government agencies. Institutional investors and commercial lenders have a greater stake in the sector's success, building a broader coalition in support of social and affordable housing. Through controlling many aspects of their finance raising and asset management policies, housing associations have established a greater critical distance from government. Finally, private finance has allowed innovation by the larger associations to provide new and potentially better social housing solutions.

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