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AFFORDABLE HOUSING BRIEFING PAPER

JANUARY 2016

1.0 Background

The aim of this briefing note is to summarise the issues facing affordable housing delivery across Scotland and the U.K. It draws on Philip Neaves' experience as a Board member of Port of Leith Housing Association and Chair of its private sector subsidiary Persevere Developments Limited. Whilst it is written from a Scottish perspective the issues it deals with are applicable across the U.K.

The Registered Housing List for Edinburgh and the Lothians shows that there are 26,000 households in need. Edinburgh City Council estimates that there is a requirement for 16,000 affordable units in the next 10 years. Available subsidy can finance c 600 units per year. Housing Associations attract an average of 138 applicants for each property offered for rent. Edindex, the Edinburgh housing association clearing house has 27,500 registered customers. The Government's subsidy is focused on the four main population centres of Edinburgh, Glasgow, Aberdeen and Dundee. This scenario is repeated across the country and exacerbated outside these four cities where availability of subsidy is restricted.

In December 2011 the Scottish Government introduced a new funding mechanism which has been described as the biggest change in the sector in 20 years. Housing Association Grant (HAG) is no longer available and is replaced by funds provided by the Government to each local authority based on the authority's Strategic Housing Investment Plan (SHIP) covering 2012 – 2015. Detailed bids submitted annually determine which projects will receive funding. There is a lower level of subsidy, benchmarked at £40,000 per unit (previously this was £70,000 – in June 2013 it was announced that it will be selectively increased to £57,000 per unit) and this is now paid on completion of the project, rather than at the start. Given unit costs of c £120,000 the housing association must now fund all the development cash flow rather than receiving c 60% upfront from grants. This is making 'turn key' projects with payment on delivery increasingly attractive.

Housing associations are charities and social enterprise companies. Many have responded to the changes through a business model that enables them to make and retain profit. Port of Leith Housing Association (PoLHA) has therefore set up Persevere Developments Ltd, which is a private sector subsidiary.

PoLHA's Annual Report states that it has a five year business plan covering 2012 – 2017 and intends to build 527 units at a capital spend of £52m. Spending is front loaded with 443 units (84%) delivered in the first 3 years. There is £16m grant funding in place and £34m new private loan funding. After completion of this pipeline financial capacity will be substantially reduced, with 50 units p.a. projected for years 5 – 19; 80 units p.a. for years 20 – 24; and 100 units p.a. for years 25 – 30. The base assumption is a 50:50 split between affordable and mid-market rent (see below) with a unit cost of £120k, with £40k grant.

2.0 Tenures

Edinburgh City Council's Affordable Housing Guidance allows for 9 delivery mechanisms:

i. Social Rent – the traditional housing association model, homes for rent offered at below market rents to those in most need
ii. Mid-market – built by a housing association and operated at a profit using SHIP subsidy. Rent is defined as up to 85% Local Housing Allowance, which is the amount paid in housing benefit in each housing market area
iii. Intermediate rent – unsubsidised MMR. Built by the housing association at its expense from its reserves and borrowings
iv. Shared equity – the tenant buys a majority share in the property. The housing association retains the remainder. The owner pays no rent and make a mortgage payment to its mortgage provider based on their percentage share of the property
v. Shared ownership – the tenant purchases a share and pays rent on the remainder to the housing association
vi. Discounted sale – property is sold by housing association or private house builder at 3.5 times average salary for the housing market area. In Edinburgh this equates to a maximum price of £122,000
vii. Unsubsidised low cost home ownership – the model is the same as discounted sale but the property is built without subsidy. This is the model increasingly adopted by house builders to overcome inability of housing associations to finance development
viii. Golden share – similar to discounted sale but with different eligibility criteria. The tenant purchases an 80% share and is required to show a local connection
ix. Unsubsidised shared equity – again similar to discounted sale. The owner purchases a 60% to 80% share but the 3.5 times average salary contribution paid by the tenant is applied to the percentage of the property they purchase e.g. if a property is valued at £200,000 the £122,000 contribution buys a 60% share. This allows affordable housing principles to extend to higher value properties

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3.0 Mid-Market Rent

MMR is seen as having the most short term potential. It is aimed at:

- Households with maximum income in range £35,000 - £46,000
- Possibly key workers
- Households at thresholds where mortgage decisions to lend/not lend are made
- Households with no problems with affordability. These households could afford to buy the property with a mortgage if mortgage were available

Mid-market rental levels in north Edinburgh, with market rents in brackets are as follows:

- I bed £475 pm (£560)
- 2 bed £565 (£760)

MMR is predicated on correct location. It will not suit every site. It needs to be underpinned by housing market research. Ideal is 2 bed flat, rather than family accommodations. Strong demand is also emerging for studio flats. The target market is young professionals. It is a step on the ladder and offers the opportunity for 'stair casing' where MMR property may become shared ownership with partial and ultimately full equity transferred.

4.0 Changing Housing Association Structures and Financial Models

As noted above, housing associations are increasingly establishing private sector subsidiaries in order to deliver development in a commercial rather than subsidised manner. The model that has been developed is as follows:

- Housing association as charity and parent forms subsidiary. Subsidiary is registered with Companies' House as a limited company and a separate corporate entity
- Housing association acquires land, obtains consents and builds property
- The subsidiary enters into lease (typically 30 years) and the housing association will manage property and be subject to service level agreement
- Subsidiary pays parent annual lease to parent. The cost is covered by rents. The model assumes a rental surplus that builds up overtime and can be used by the subsidiary to leverage debt. Subsidiary is responsible for:
    1. Finding tenants
    2. Managing voids
    3. Fixing rents and collecting payments
    4. Ensuring that rents are fixed at such a level that collective value exceeds lease fee
    5. Ensuring voids and bad debt is minimised so that differential between rental income and lease fee is not eroded

The opportunity that exists for private developers or investors is to build and lease properties for the housing association. The commercial subsidiary of the housing association will then operate. Key due diligence considerations for investor is as follows:

- Housing associations are regulated by the Housing Regulator and have effective Scottish Government covenant
- Provided subsidiary remains part of housing association group of companies it is underwritten by housing association and ultimately Scottish Government covenant
- Investor receives a single lease fee payment made either annually or quarterly. That payment will be on terms to be agreed but is likely to include annual uplift of inflation plus 1%
- It is for leasee to find tenants, collect rents, deal with debt and voids
- Security for lease is the extent of need and demand in the market. Leasee can offer property for MMR or full market rent. Current extent of demand indicates no foreseeable reduction in demand. Void length is determined largely by redecoration time not by time taken to find new tenant

Without tax breaks or establishment of Residential REITs it is questionable whether a capital markets based funding solution can be found. Many people in the market have been exploring the opportunity outlined above but the difficulty is providing investors with the level of return that they seek and a saleable investment, whilst not undermining the commitment to affordable rents and pricing that is the reason for the existence of housing associations. The Government is exploring creation of a bond that it will sell in order to create finance for the use of housing associations. In England several housing associations are considering issuing their own bonds. The market in Scotland is too small for anything other than a Government bond.

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House builders are moving back to the 'partnership' model last used in the mid-90s where house builders had a social housing subsidiary. There is evidence of developers committing to use CEC affordable housing delivery mechanisms ii) - ix) outlined above if they cannot reach agreement with a housing association to deliver a scheme.

House builders are also using the Resonance model developed by Retties. An example is Pinkhill in West Edinburgh. Under Retties Resonance guidance can be summarised as follows:

- The housing association borrows against future income stream from the property. Crucially, shortfalls in that income stream are covered by Government guarantee
- The funds borrowed by the housing association are transferred to the house builder on completion
- The house builder allows its units to be used by the housing association for MMR or similar tenancy for a specified period, usually between 5 and 10 years, but retains the right to take back the properties and reimburse the housing association at any point
- At the end of the period the properties are sold and the funds passed back to the developer with the housing association retaining its original properties.

In this way 25% affordable housing is achieved for a time but not in perpetuity. The problem of the sold units is overcome in theory by other developers also adopting the Resonance model so that new supply replaces units that are sold. Resonance works if the number of units entering the model each year matches the sale commitments.

Borrowing against future income streams is risky but the risk is covered by the Government guarantee. The National Housing Trust has a similar model, the difference being at the end of 10 years all properties revert to the developer for sale.

There are questions about Resonance, in particular new supply to replace units at the end of the agreed lease period. It is a model to meet a current need and is probably a temporary solution to housing economics, whilst a housing bond or similar scheme is developed. Resonance allows for medium term supply at levels currently sought by policy and ensures that the inability to finance affordable housing through traditional methods does not stop a scheme receiving planning permission with the consequence that no units would be built.

Resonance therefore raises questions about how to maintain supply in perpetuity. In our view, this is not achieved by planning conditions attached to each consent but by maintaining policies that allow for new dwellings to come forward replacing those that are sold.

Resonance requires sound valuation methodology. The RICS guidance on valuation identifies two approaches, comparison and residual value, but notes that the site specific restrictions on affordable housing land makes comparison method difficult. It notes that the type of tenure permitted will directly impact on values. Affordable housing also has higher costs because of the requirement to build for 'Housing for Varying Needs' which is more onerous than building regulations. If a commercial subsidiary is being used by the housing association that subsidiary is liable to stamp duty. Finally, the switch to receipt of grant funding on completion makes 'turn key' development increasingly attractive to the housing association.

An alternative model that has been adopted by some planning authorities has been to accept payment equivalent to 25% of the units being provided as serviced plots. This money, which amounts to approximately one third of the development cost, is then used by the local authority as a substitute for Government grant to either fund part of full cost of development of affordable units. This means that the money provided against affordable housing contribution can fund approximately 8% - 12% on site or offsite affordable housing. The key is that it actually delivers housing on the ground.

Philip Neaves was involved in a study of affordable housing delivery in the Lothians in 2006. This study found that despite each authority having a policy target of 25% the best delivery result between 2002 – 2004 was an average of 12% in Edinburgh. The worst result was 6% in West Lothian.

The latest development is a National Affordable Housing Loan backed by the Housing Finance Corporation, which will cover U.K., including Scotland. This will provide triple-A rated Government backed 30 year loan in £5m chunks. Work is on-going to see whether it is possible to make this an off balance sheet loan to the non-charitable subsidiary with the loan being paid in the first instance to the housing association, and then being transferred.

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