Funding affordable housing – New options for housing associations?

a Public Sector Research Centre publication

talking points

PricewaterhouseCoopers

talking points

Contents

Introduction

Housing associations play an increasingly important role in today's housing market. They are leading suppliers of affordable – both rented and shared ownership – homes, major partners in regeneration and estate renewal, and providers of a wide range of vital welfare services to the most vulnerable in our communities.

Housing associations (or Registered Social Landlords – RSLs) form the largest not-for-profit grouping in the country, working closely with both private and public organisations. The sector has grown dramatically following the large-scale voluntary transfer of council homes in the 1990s. Housing associations in England now own some 2m homes (around 9% of the total housing stock), worth around £77 billion. The sector boasts reserves of around £11 billion, a turnover of some £9 billion and net rental income of over £7 billion.

The sector is diverse, with around 1,900 associations varying in size from under 10 homes to more than 50,000. The 60 largest associations own just over half the total stock and fewer than 30 account for the majority of investment in new homes. Housing associations provide homes and local services for some of the poorest and most disadvantaged households.

The concentration of workless households in the RSL sector has increased, and John Hills in his recent landmark study[1] showed that nearly half of all social housing is in the most deprived neighbourhoods. Hills estimated that 63% of social housing tenants are on benefit, a third are retired, and a fifth are single parents. Moreover, his study suggested only a third of social tenants of working age are in full-time employment.

The sector has doubled its output of new affordable homes since a low point in 2003 to around 45,000 and expanded its range of housing options, including offering more intermediate housing and some homes for sale. As major owners of assets with access to private finance, the Government wants the sector – along with local councils – to play a more active part in the supply of new homes and an even greater role in helping turn around deprived mono-tenure estates.

Housing reforms

The drop in lending due to the credit squeeze and the sharp reduction in private new-build have increased the pressure on housing associations to maintain the flow of affordable homes in all areas of the country. Other reforms emanating from the Cave[2] and Hills housing reviews – including new equity share products, more 'tenant facing' regulations, a new Homes & Communities Agency (HCA), and modernisation of the social housing subsidy system – are also making extra demands on the sector. More reforms to the social housing sector are expected in the forthcoming Housing Reform Green Paper, which is likely to focus on the housing benefit system and delivery of housing services.

This "Talking Point" examines the funding considerations that follow from these policy changes and challenges. In particular, it considers the options for new and innovative ways to utilize housing association assets and financing capacity. Against a backdrop of macro-economic uncertainty and tighter constraints on public spending and private lending, it also considers the feasibility and suitability of the delivery metrics for affordable housing (especially in regard to creation of mixed income communities and estate regeneration).

1 CLG/LSE, Ends & Means: The Future Roles of Social Housing in England, John Hills (2007)
2 CLG, Every Tenant Matters: A Review of Social Housing Regulation, Martin Cave (2007)

Developing new forms of funding

The challenge

The government is committed to a significant increase in the delivery of affordable housing. To achieve this it has increased its funding allocation to the Housing Corporation to £8.4 billion over the spending review period 2008-11 (compared with the previous funding allocation of £3.9 billion over two years). It is expecting housing associations and other development partners of the Housing Corporation to deliver at least 45,000 new social homes for rent and over 25,000 shared-ownership homes a year. In short, for an extra 36% of funding, the government is expecting the sector to deliver 52% more units of affordable housing.

Everyone recognises that this target will be a challenging one – indeed, if grant rates were to remain at current levels, the government would need to increase its spending by £2 billion to finance its target of 70,000 new affordable homes a year. So where might these efficiency savings come from? The Housing Corporation produced evidence that indicates the sector has the financial capacity (and capability) to reduce grant rates by 10%. A significant saving, but it will not be enough to bridge the funding gap completely.

The new national HCA (which combines the resources, powers and expertise of the Housing Corporation and English Partnerships with some elements of the Department for Communities & Local Government) has the potential to bridge the funding gap. For example, it gives rise to the possibility that new funding approaches will emerge that unify the grant-backed programme model of the Housing Corporation with English Partnerships' investment model.
The English Partnerships model, which involves the funding of pre-development works on large and complex sites (with the funding coming in the form of investment that earns a return) could be used to create the platform for new housing development. However, there are concerns that market instability makes innovation difficult and that the sector is better served by staying with the status quo. Others suggest that the creation of HCA is a golden opportunity to apply the "investment" model to the funding of affordable housing.

From grant to co-investment

Under an investment scenario, the HCA's funding contribution (which is now grant) would have the attributes of an investment or equity stake in properties. This contribution would form part of the overall capital contribution to new affordable development (whether affordable housing or a mixed housing development). In simple terms it would mean that the new agency would benefit from the value gain that crystallises as low-cost home owners staircase up or when these properties are sold outright by housing associations. In a more limited form these principles could also apply to housing for rent.

Despite the public sector's growing expertise in the use of investment there are concerns that in the current market the present grant-based funding mechanism may be unsustainable.[3] The conventional funding regime, for example, provides the Housing Corporation with no capital appreciation or return as the values of the properties it co-funds increase. Work undertaken by PricewaterhouseCoopers' housing finance team on a limited sample of shared-ownership units has indicated that returns accruing to the new agency under an investment model could equate to £13,000 per unit (using a house price index of 2.5% per annum). If this metric were replicable across the sector, then twice as much low-cost home ownership housing could be funded from existing resources (average grant rates being around £26,000 per unit).

The creation of the HCA provides an opportunity for the sector to construct a dialogue on new funding approaches – approaches that recognise the part that both housing associations and government funding play in the financing of affordable housing and the creation of value. In its basic form the new Agency's role would be one of a passive investor, and housing associations might simply be required to recycle a larger portion of the receipts generated from asset sales. If a more active investor model were followed, housing associations would return grant (with the appropriate return) to the HCA when assets were sold on, allowing the agency to redistribute these receipts across the sector in accordance with its delivery priorities.

The need for the sector to respond to the funding challenge is made greater by the recent rapprochement between central and local government. The recent housing green paper offers local authorities the opportunity to deliver new affordable housing. This call to arms is to be reinforced by new delivery models (local housing companies and strategic housing and regeneration partnerships) and reform of council housing finance that could secure additional funding support. A number of local authorities are positioning themselves as delivery agents and believe they can provide affordable housing at a significant discount on current grant rates. Housing associations that are not strategically astute may find that resources are redirected elsewhere.

3 CLG, Homes for the Future: More Affordable, More Sustainable (July 2007)

From management to intervention

The government has placed a greater emphasis in its housing and place-making agenda on creating mixed communities (i.e. those communities that contain a mix of tenures and incomes). This more interventionist approach to estate renewal is informed by area effects analysis in the USA, which crystallised in Clinton's $5 billion HOPE VI housing programme.

The rationale behind promoting mixed communities is that life chances in very low-income areas are adversely affected by stigmatisation, low quality of services, low expectations, poor transport connections and even poorer connections to local labour markets. Furthermore, the problems of multiple deprivation are made even worse in areas where there are concentrations of distressed, mono-tenure housing. In mixed-income neighbourhoods there is evidence to suggest that the characteristics of low-income neighbourhoods do not prevail on the same scale.

The bulk of existing social housing is not in mixed neighbourhoods – 60% of it is still in areas originally built as council estates and 50% of it is concentrated in the 20% most deprived 'super-output' areas. Housing associations work in many of these communities, and, more importantly, understand the types of intervention that are needed to transform them. But large-scale estate remodelling is complex as it inevitably affects the lives of the existing community. It is also costly as it interrupts the flow of rents (worth millions of pounds) that are needed to meet the principal and interest payments on existing loans. In addition, it requires tens of millions of pounds of borrowing (to finance development and construction work), with a large part of these costs being repaid with the revenues generated from the new housing for sale.

The future of many of our communities is dependent on interventions of this type, and in many places the organisations best placed to take the lead are housing associations. So what are housing associations doing, and can they do more?

3 UK House of Commons Treasury Committee 'Financial Stability and Transparency' report, February 2008

The balance sheet approach

For many years housing associations have undertaken estate-based regeneration projects, in relation to both their own stock and that owned by local authorities. In some instances they have worked in partnership and in others have taken the lead delivery role. Whether housing associations play the lead role or a supporting role, they will face commercial risks (including planning, demolition, construction and development risk) that are very different from and less well understood than those associated with the more traditional business of stock management.
In numerous instances housing associations have funded regeneration projects by sweating their assets: that is, they have used their housing assets as security for additional borrowing. The reasons for doing this are quite straightforward: first, they have the capacity to do it; second, it provides a real commercial advantage (particularly when there is a competition for the right to develop) as borrowing rates are typically 50 basis points lower than they would otherwise be. Financially, it means that a project or development is less expensive to finance.

But funding development on these terms does expose a housing association's balance sheet to real commercial risk, as funders will have access to an association's assets if the project or business plans turn sour. In practice difficulties in meeting debt repayments are more likely to mean that an association will be forced to dispose of its assets to raise the capital it requires to meet its debt obligations. And on complex regeneration projects, liabilities may accrue quite quickly if there are delays to planning approvals, construction cost increases or lower-than-expected values on private housing sales.

Whilst housing associations should be encouraged to make their balance sheets work harder, it is equally important that the risks of balance sheet financing are properly assessed and understood. Some of the key questions that a housing association needs to answer include:

- Are the project risks understood, and does the housing association have the skills, expertise and resources necessary to manage the risks and deliver a project as a sole sponsor? Will partners be required?
- What is the opportunity cost of using corporate assets as security, and do the lower funding costs make a material difference to the cost of delivery?
- Would such an undertaking affect an association's debt-raising capacity in the future?
- Does the additional risk, particularly in terms of its security obligations to its lenders (which should be quantified), outweigh the potential benefits of lower funding costs?
- Will the arm's-length role of lenders reduce the rigour of lender due diligence and place an additional risk on the housing association?

The limited-recourse model

Whilst the case for and against balance sheet funding is not straightforward, there is little doubt that it does place additional risk on a housing association. It is also likely to limit the scale of project a housing association can embark on, and its ability to run a number of similar projects in parallel. In short, new thinking on scheme financing is needed if housing associations are to deliver estate-based regeneration projects on a significant and sustainable scale. So what might housing associations do in response to this challenge?

One way in which housing associations could limit their balance sheet exposure and leverage more funding to increase activity levels is through the limited-recourse approach that is favoured by the private sector for exactly the same reasons.

Under a limited-recourse model a housing association would set up a project company or special purpose vehicle (SPV) to deliver a specific and well-defined set of outcomes. It could do this in its own right or the SPV could be jointly owned by a number of partners or stakeholders. The SPV would be responsible for the development and construction of affordable housing (and potentially private housing for sale) and the refurbishment of the existing housing.

The SPV would raise the financing needed to deliver the project and would engage subcontractors to deliver the new housing and other capital investment. These subcontractors might be the same organisations that own the SPV, but the roles, responsibilities and relationship between the SPV and the subcontractors are separate and based on a formal contractual relationship. The revenues secured from housing sales (both affordable and private) are used alongside other revenue streams to repay the sums borrowed from lenders.

On projects funded in this way it is possible to secure 90-95% of the funding required from a bank or other debt provider. Typically bank (or senior) debt is priced at LIBOR (the London Interbank Offered Rate), to which a margin is added to reflect the risk profile of the project borrower. This rate is usually fixed (hedged) at financial close, thus negating the risk of interest rate movements during the life of the project.

Finance raised in this way is generally more expensive than traditional housing association funding, because it is not secured against the assets of the housing association but against the revenues to be generated by the project. In this way the housing association's balance sheet is protected.

But a housing association cannot mitigate risk completely. Between 5% and 10% of the project funding will need to come from the project sponsors (the owners of the SPV). This could be funded from cash reserves or the value of any assets (land or property) that the housing association is contributing to the project. Equity is by definition risk capital, and equity returns will only be earned if the SPV delivers sufficient revenues to permit the payment of dividends. The high gearing (debt:equity structure) means that the weighted cost of capital and the cost of financing a project are lower than is typically the case for more speculative or uncertain developments.

The limited-recourse nature of this form of financing means that if the project were to suffer financial difficulties or to fail, the recourse of the lenders is limited to the share capital committed by the project sponsors (typically 10%). As lenders are dependent on the project revenues being sufficient to repay the loans they have advanced, the project will be subject to significant due diligence (which in itself should be of comfort to a housing association). A number of housing associations have delivered, or are working up, projects using limited-recourse structures. The approach is attractive not just because of the contractual and financial rigour that accompanies it, but because it is particularly well suited for large and complex projects.

Conclusion

The current three-year spending review has put more housing resources on the table than the sector has seen for decades. But the challenge is great, for both delivery metrics for affordable housing and the efficiencies that need to be achieved. In addition, there remains the massive challenge of estate remodelling, which is so critical to the long-term viability of many of our communities. Housing associations remain well placed to respond on both of these fronts.

But a step change in the delivery of affordable housing and mixed communities in the current housing market will require fresh thinking on new ways to deliver new funding. Without that step change there is a risk that delivery will be truncated and progress will only be piecemeal.

Contacts

Head of Housing and Communities

Richard Parker
+44 (0)121 232 2455
richard.parker@uk.pwc.com

About the author

Richard is the Head of PricewaterhouseCoopers' Housing team. He advises both public and private sector clients across a diverse range of Government housing and regeneration programmes. He led PwC's contribution to a debate on 'target setting' in housing, which PwC sponsored with a leading 'think tank' – the Social Market Foundation. He also led the firm's housing policy review – 'From Decent Homes to Great Places'.

He has advised on the largest and most complex Housing and Regeneration PFI Projects that have been completed in the UK and which have secured over £2bn of private finance (including projects at Islington, Manchester, Sandwell, Reading, Newham and Camden). Richard has advised the UK Government and the Housing Corporation on PPPs and led the firms work on the national guidance that has been published on PFI and PPPs.

More recently Richard has been advising the Government on its 'Mixed Communities' initiative which is targeted towards areas of acute deprivation and he is advising a number of public authorities on creative ways of using under their under utilised assets as a lever for economic regeneration.

About PricewaterhouseCoopers

PricewaterhouseCoopers has a dedicated Housing and Regeneration team that is advising on every major housing policy programme; including housing PFI and Public Private Partnerships, regeneration projects, key worker schemes, and housing market renewal. We provide our clients with advice on policy, strategy, procurement, structuring and finance raising, and we have a reputation for bringing our clients a new perspective.

PricewaterhouseCoopers is a leading provider of financial, procurement, tax and accounting advisory services to the public and private sectors on PPP and project finance projects around the world. We have provided advice on over 400 signed projects, with a private financing requirement in excess of US $89 billion, and consistently rank in the top 5 of the Thomson Financial annual Project Finance International League Tables.

About PwC Public Sector Research Centre

PricewaterhouseCoopers' Public Sector Research Centre (www.psrc-pwc.com) provides insight and research into views and attitudes as well as best practice in government and public sector organisations – including the interface between the public and private sectors – throughout the world. We draw on the thinking and perspectives of these organisations themselves, our own global network, and leading think tanks and academies to enable a collaborative exchange on the most pressing issues and challenges facing governments and the public sector.

www.pwc.co.uk/housing