

**JRF programme paper:
Housing Market Taskforce**



Increasing supply within the social rented sector

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December 2010

This paper:

- examines how social housing has been funded;
- discusses the impact of the recession and change of government on the funding of social housing; and
- sets out how affordable social housing can be delivered in the future.

The Joseph Rowntree Foundation (JRF) commissioned this paper to contribute ideas for its Housing Market Taskforce, a two-year programme of work aiming to achieve long-term stability in the housing market for vulnerable households.

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This paper was commissioned to inform the work of the JRF Housing Market Taskforce, a two-year programme of work aiming to achieve long-term stability in the housing market for vulnerable households.

The Joseph Rowntree Foundation has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policy-makers, practitioners and service users. The facts presented and views expressed in this report are, however, those of the authors and not necessarily those of JRF or the Housing Market Taskforce.

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Introduction

The Joseph Rowntree Foundation (JRF) has set up a Housing Market Taskforce (HMTF) concerned with understanding and promoting policies to reduce housing market volatility i.e. a 'socially sustainable' housing market which avoids extreme fluctuations of boom and bust and in which vulnerable households are less exposed to the consequences of market volatility. As a consequence of this, the Taskforce is interested in the potential role of rented and 'intermediate' market housing to provide means of increasing flexibility, alternatives and stabilisation within a housing system dominated by owner-occupation. In this light, the Taskforce also wants to investigate the extent to which the increased supply of social rented housing may act in a counter-cyclical fashion and provide a safety net to households who face affordability problems or are on low-incomes.

This paper, therefore, has been commissioned to look more closely at the funding of new social housing. It was originally drafted before the general election in May. Since that time the new Coalition Government's social housing policy has begun to emerge. Where appropriate we have reflected on the issues in this paper.

This paper includes: a brief overview of the principles and practice of funding for new social housing (council and housing association) over the last decade; an assessment of the impact of the credit crunch and recession on existing funding mechanisms for social housing; consideration of the viability of existing funding mechanisms and whether recent financial and economic shocks have permanently or temporarily affected the existing funding model.

In the longer term, given the ongoing expectation of fiscal austerity, what viable or feasible future mechanisms might contribute to the Housing Market Taskforce's objectives are also explored. This paper also examines: the potential role of 'near-market' renting for those priced out of the market or vulnerable to market volatility risks; potential sources of both new and existing funding for social and near-market rented housing; the prospects of attracting institutional investment to the near-market rental sector – either directly or through housing associations; and, what subsidies (including tax concessions) might be required to attract such investment and to what end?

The structure of the rest of the paper is as follows. Section 2 is an overview of in-principle subsidy mechanisms. This is juxtaposed in Section 3 with the main existing funding mechanisms for social housing in England and Scotland and the latest developments from the new Coalition Government and north of the border. Section 4 looks at the impact of the credit crunch, housing and wider economic downturns in terms of lessons for alternative funding mechanisms and Section 5 is an overview of alternative international models that are mindful of the fiscal austerity context and also work with the grain of market and institutional developments. Section 6 focuses specifically on the ideas behind a near-market rental sector. Section 7 concludes with some thoughts on how additional homes might be delivered within the current environment.

In-principle funding mechanisms

Principles

If we accept that, typically, new social housing will require an element of borrowing (be it from private sources or from public sector funds), subsequent development, one way or another, will require borrowing capital and servicing the subsequent debt. This can operate through a series of models involving mortgage and other collateral debt (e.g. a charge on unencumbered assets), public sector loans and bond finance, but also, potentially, private equity and other partnership arrangements (e.g. Public Private Partnership arrangements with council housing or housing associations with private developers or local government, and this may but need not include planning agreements).

Essentially, any funding package has to both allow development to take place and ensure that the repayment profile is affordable to the occupier and landlord in such a way that other related housing goals are met (e.g. provision for management, maintenance and major repairs as well as the servicing of debt). Key issues will relate to the nature, extent and implications of the subsidy on offer, as well as the price of land and obligations associated with it (e.g. if part of a planning agreement mixed community site, does the development have to take a certain form). New social housing has to overcome certain fundamental risks if it is to be viable. Questions of track record and management performance, demand, housing benefit risk, etc., all come into play. One can think of the different generic models as alternative ways of matching the needs of the social housing provider with the financial interests of the ultimate lenders of funds. Later on we extend this matching to consider the emerging range of deals that can be done to deliver new affordable housing through all manner of specific opportunities (e.g. cross subsidy, partnership working, innovative financing, etc.). We start, however, by looking at the principles of housing subsidy.

The in-principle case for subsidised social housing finance systems rests with fundamentally efficiency and redistributional arguments (Whitehead, 2003; Hoek-Smit, 2009). Below, we look briefly at the reasons for supporting new social housing, the case for subsidy, the debate around the form subsidy should take, leading us to generalise a few principles for subsidising new social housing.

The JRF Housing Market Taskforce argument for new social housing – increased supply helps stabilise the housing system as a whole and provides affordable alternatives to those excluded from home-ownership or the private rented market – is only one of several arguments that might be put forward for expanding the supply of social housing. There is also an argument that originates in concerns about public health issues associated with overcrowding and homelessness, which also speaks to the wider social, educational and health benefits attributed to investment in good-quality affordable housing.

A related pragmatic argument (particularly in a recession) is that social housing investment will generate large employment and output multipliers (Smyth and Bailey, 2009) of as much as 1.9, which is important to sustain construction and wider sector capacity during a downturn. The scale of council housing development carried out post-war and during the 1960s and early 70s certainly helped provide that economic boost but since then there has been a move away from building large mono-tenure estates, which has meant looking at such development programmes differently in the current economic cycle.

The combination of household circumstances, market failures, sluggish supply responsiveness and the establishing of official thresholds of adequacy and need, leads to measured levels of housing need unmet by market solutions. The main reason for new social housing correspondingly stems from the requirement at local and regional levels to develop rolling programmes that will generate sufficient affordable housing, including new social housing, to meet this measured need (Hills, 2007). These targets then interact with other government objectives in the form of policies to regenerate existing social housing neighbourhoods (e.g. through redevelopment which may increase the overall supply of the effective stock by replacing low demand housing with higher demand housing, or it may simply replace supply sometimes at lower densities) or to use local affordable housing policies to promote mixed tenure schemes through planning agreements, etc.

It should be clear that many of the reasons for advancing new affordable housing do not necessarily imply a case for advancing new *social rented* housing. While it is clear that the social housing sector is expected to widen the range of affordable housing offers, demand-side subsidies to low income market renters and mortgagors, along with discounted and low-cost home-ownership, will also provide solutions. Moreover, there is considerable criticism in certain quarters of the efficiency, management, sustainability and viability of aspects of social housing in the UK (Dwelly and Cowans, 2006). As the earlier arguments imply, the existing social housing system is generally better placed to respond counter-cyclically in a recession and that wider construction/development benefits may also lead to benefits in terms of ongoing superior housing outcomes – although this is also dependent to a great extent on sufficient funds being made available through grants and equity being released from public sector land and housing association balance sheets.

A defining feature of social housing in most countries, and certainly in the UK, is that of below-market rents and other forms of explicit subsidy. A reasonable question to ask is ‘why subsidise housing?’ There are several reasons. First, on efficiency grounds it is conceivable that subsidy is the appropriate response to a specific housing market failure (i.e. more suitable than say regulatory interventions alone). Second, subsidy is a simple and direct way to address basic housing needs where there are affordability constraints on tenants and finance constraints facing landlords. A third reason, harking back to Beveridge in the 1940s, is the need for a sufficiently comprehensive approach to personal housing subsidy that will overcome large regional

variations in housing costs. A fourth reason may be the consequence of new policies imposed on social landlords that have financial implications and in turn require subsidy to achieve, particularly where this may also encourage a desired form of policy outcome e.g. housing quality standards, implementing Scotland's homelessness legislation, climate change proposals, etc. Although there are probably many other reasons for subsidy it is important, fifth, to note the wide range of subsidy mechanisms operating in the social housing system. If we define subsidy as a deviation from a market rent – this may arise because of an explicit subvention from the state but it might also arise from regulatory policy (e.g. rent convergence) through accounting practice (e.g. historic cost accounting or pooling) or because of the better lending terms and conditions available to local authorities from the Public Works Loan Board (PWLb).

Demand- or supply-side subsidies

If the case for some form of subsidy is accepted then the next stage of the argument is to consider which type of subsidy – demand (person or subject-related) or supply (object or in-kind) subsidy? Demand-side subsidies (suitably designed) are typically preferred by economists, whereas they point to the efficiency losses associated with supply subsidies to public housing (reviewed in Green and Malpezzi, 2003). However, the argument is in reality more complex and specific to individual systems and market contexts (Galster, 1997; Yates and Whitehead, 1998). The case for supply subsidies is supported in Whitehead (2003), highlighting that social housing has the capacity to actually deliver the required additional housing. Supply subsidies can also demonstrably meet other social policy ends such as labour supply incentives – the multiple objectives of social security and low-income housing policy often can be at odds, with means-tested housing subsidies reducing incentives to do extra work or save because of loss of benefits. More abstractly, price subsidies can address externalities more effectively and meet merit good objectives in a way that demand-side subsidies cannot. Whitehead (2003, p142) also contends that in a second-best world where there are also distributional objectives, to the extent that housing has a low price elasticity of demand, in-kind transfers of housing may induce less distortion of those distributional objectives than income transfers.

If there are to be supply subsidies, what form should they take? The usual distinction is between capital and revenue, though there is no necessary reason to have one without the other, even though there may be arguments favouring one route over the other. Of course, revenue and capital subsidy can be designed to be effectively equivalent but rarely are developed in such terms. Revenue or recurrent subsidies imply an ongoing financial relationship between the landlord and the state and is inevitably subject to wider political currents. Up front capital subsidy is far more of a burden to the state but is likely to have regulatory rather than financial risks (i.e. of policy change impacting on the financial position of the provider) going forward for the landlord. Hills (2007) supports moving towards a recurrent subsidy system for all social housing and removing up front capital subsidies, although as is evidenced by the previous Government's proposed council housing reforms,

such arrangements do not easily lead to the most effective form of asset management as successive governments have tended towards a short-term financial perspective.

What form might these subsidies take? Capital subsidy might be in the form of grants, or subsidised loans with different ways of reducing the interest or principal cost relative to the going market cost of an equivalent risk-adjusted investment. Loans to landlords may be guaranteed and this in turn may lower risk and the cost of funds. Some landlords, as public bodies, may be able to take out loans on more generous terms and conditions. Revenue subsidies can also take many forms including explicit deficit subsidies reducing required rental income, forms of allowances for certain direct landlord activities, or it might be more explicit, such as a below market rate of return on investment. Indeed this latter arrangement was considered as part of the council housing reforms but ultimately rejected.

What principles emerge from this short discursive overview? Subsidy systems should be efficient, sustainable and fair. More specifically, they should be:

- Robust and able to withstand shocks over the often quite long periods of housing investment repayment profiles
- Able to work with private funding efficiently and without creating distortions or other unintended consequences
- Consistent with society's ideas of delivering affordable rents and prices
- Transparent and simple to understand
- With the grain of other associated social policies relating to, for example, labour incentives, worklessness and mixed communities
- Responsive sufficiently to allow efficient and timely new supply where required
- Designed so that they (through pricing etc.) have a neutral or complementary impact on local housing systems, other tenures and private developers
- Such that they offer good value for money for the public purse, keep costs under control and allow for an appropriate financial and regulatory relationship between state and landlord.

In practice – existing social funding mechanisms

Social funding in the UK at present is primarily split into two types: demand-side funding provided through housing benefit (or in the private sector, local housing allowances) to help tenants who cannot meet all their rent; and supply side funding provided to social landlords to help ensure that properties can be let at 'affordable' levels for people on the lowest incomes. Housing benefit represents around two-thirds of the income received by social landlords.

Social housing landlords throughout the UK are split between housing associations and local authorities (except in Northern Ireland where the Northern Ireland Housing Executive owns around 75 per cent of the stock). Development of new social rented housing over the last two decades has been by housing associations, as they are currently classified as being outside the public sector.

There are slightly different systems in Wales and Northern Ireland but for the purposes of this analysis we focus on England and Scotland.

England

At present the supply side for new social rented housing in England has been subsidised through a number of systems over the last 20 years or so:

- (i) The capital grant system (Social Housing Grant). This has been used primarily in the housing association sector to discount the up-front costs of acquiring and constructing new housing – sometimes offset by the provision of free or discounted local authority or other public sector land.
- (ii) Section 106 (S106) funding – this is in essence a developer tax which imposes a requirement to provide additional social housing (and/or other social contributions) on private developments over a certain size and dependent on location.
- (iii) Private Finance Initiative – this has been used on a fairly small scale on some social new build schemes and is funded through revenue support to the council who in turn pay a separate contractor, usually involving a housing association, to build the new housing, normally on existing council-owned land.
- (iv) Other capital grants – there have been various other initiatives (e.g. Single Regeneration Budget, New Deal in the Community) over the years which have been used to regenerate existing (mainly council) estates, some of which has gone towards new and replacement social housing.

Over the last two decades the various programmes and mechanisms have delivered around 0.7 million new social rented units, the vast majority via the capital grant system although S106 has also been important. Until the previous government extended its new build initiative to councils and Arm's Length Management Organisations and private sector bodies in the last few years this had been delivered almost exclusively by housing associations.

Whilst this new build programme may seem significant the existing local authority sector has reduced considerably through right to buy sales (around 1.3m since 1990).

Around 75 per cent of the receipts from those sales were initially used to repay debt and simultaneously reduce revenue subsidies to local authority landlords. Since 2005 about the same proportion has been paid back to government although sales have significantly declined during that period. There has been no direct relationship at a national level between receipts from the right to buy and new housing delivered primarily through the National Affordable Housing Programme (NAHP) and its predecessors. Some of the 25 per cent balance retained by authorities has been used to help fund new housing association units but this makes up a fairly small proportion of the number of new units.

Consequently there has been a net loss of around 0.6m social rented units across the two sectors over the last two decades. This lack of investment in replacement units at a time when the population is increasing and household formation changing, has undoubtedly been one of the contributory factors to the lack of supply and, arguably, the escalation in house prices over that period.

A significant proportion of council stock (over 1.1m) has also been transferred to the housing association sector during the past two decades. The remaining stock (around 1.8m) continues to operate under the existing national Housing Revenue Account (HRA) subsidy regime in which surpluses from low debt authorities are used to support deficits in high debt authorities. This produces a small national surplus (around £0.2bn in 2009/10).

The amount of grant funding per unit for new social housing built or acquired in the housing association sector (and now to a small extent in the authority sector) is driven by the level of subsidised (formula) rents across the sectors (the 'domain') and the estimated cost of managing, maintaining and providing for future investment in those properties. During the recent credit crunch the Housing Corporation (HC) and its successor, the Homes and Communities Agency (HCA), increased grant rates on some schemes facing particular difficulty but otherwise the trend over the last decade has been towards reducing grant rates.

The trend towards lower rates has been a consequence of a number of factors but one key reason has been the perception by the HC/HCA that associations are able to cross-subsidise new developments from equity on their own balance sheet – suggesting that earlier grant rates may have been

too generous perhaps – or that associations are becoming increasingly efficient and outperforming their business plans.

Across the housing association sector this has been helped to some extent by the continuation of stock transfer, which has enhanced the sector's ability to extend economies of scale through merger, group structures and greater rationalisation.

This lies in stark contrast to the council sector where, for much of the last 20 years, the restrictive HRA Subsidy regime has played a significant part in limiting investment not only in the existing stock but also in any new affordable housing. The former Labour Government issued new proposals to the sector on 26 March 2010 which, if followed through by the new Coalition Government, will enable councils to have more control over their finances than they have had previously as a consequence of a one-off adjustment to the authorities' debt (this will mean around 75 per cent of authorities taking on debt and the remainder having debt paid off).

The proposals will also provide some scope for additional borrowing. This is expected to be aimed mainly at additional investment but the Brown Government also indicated that it believed there would be scope to support some new development from within the global sum provided. The figure quoted in the then Minister's Statement suggested that a further 10,000 could be added before the end of the next parliament in addition to the 4,000 which are being funded under the last government initiative.

The scope of authorities to deliver on new build will depend to some extent on their own assessments of the proposals, the amount of land they have available and the amount that may need to be targeted at improvements to existing stock. It will also depend to some extent on the accounting changes being considered by the Chartered Institute of Public Finance and Accountancy (CIPFA). The present accounting rules, under which local authorities operate, do not offer the same level of flexibility as the company accounting structure under which housing associations operate. An alternative model following the municipal company (or public corporation) model (explored below) and similar to that used abroad would enable authorities to take advantage of the more flexible accounting structures.

Another key issue affecting the delivery of social housing and new housing generally is the release of local authority – and other public sector – land as well as the capability of the authority to deliver planning consents.

The amount of actual housing debt in the local authority sector is currently around £16bn. This is less than the level of debt supported by the subsidy system (of around £20bn) but is expected to rise by a further £2bn in the next couple of years. The HRA Reforms of 26 March have also proposed a further increase of around £3.5bn nationally – some of which will be recycled into decent homes investment. The total debt per unit across the 1.8m remaining council dwellings might therefore be expected to rise to around £12,000 or £13,000 in the next few years.

This is still less than the amount of borrowing in the housing association sector which is now estimated at over £20,000 per dwelling. This is to be expected to some extent as association stock is newer, generally in better condition and has higher rents under the current rent restructuring rules. However, associations do have to pay VAT, which costs the sector an estimated £0.5bn per annum (in England) particularly on repairs – which is an additional financial burden that local authorities do not have to incur (as they are able to recover VAT) – and will be increasing following the Budget decision to increase basic VAT from 17.5 per cent to 20 per cent.

The overall spare capacity on association's balance sheets in England has fallen, according to a recent report by the Tenant Services Authority (TSA), from around £3.6bn in 2006 to around £2.7bn in 2009. The additional capacity within the authority sector will depend on if, how and when the reforms are introduced but the current accounting system does not provide as much flexibility as the association sector – although councils are able to access much cheaper borrowing at present through the Public Works Loans Board.

However, ultimately the ability of social landlords to borrow against the strength of the balance sheet depends, significantly, on the rent regime in operation.

Social rents are heavily controlled in England following the rent restructuring reforms introduced about a decade ago and are calculated in relation to a formula which takes account of regional manual workers' income and relative capital values and bedsizes. Nevertheless the difference between social and market rents varies significantly across the country and in some areas the implicit economic subsidy is far higher than in other places.

New Coalition Government

The Coalition Government's housing policy has begun to emerge following the general election in May this year and will have an impact on social housing across the UK, but in particular England. A key plank of the new government's overall policy is to make substantial savings in public sector spending as a way of driving down public sector debt. Many of the key strands to the policy are linked to that overarching objective and will be included in the Localism Bill where appropriate:

- (i) The new government has indicated it plans to abolish the TSA and transfer some of its key regulatory functions to a separate statutory committee within the HCA.
- (ii) It has pledged to abolish the existing council housing finance system in line with the previous government's initiative and replace it 'with a transparent, self-financing arrangement that devolves power to councils and will enable tenants and local taxpayers to hold their landlord to account for the cost and quality of their housing'..

- (iii) The Coalition Government is also planning to abolish the current housing benefit regime along with other benefits (e.g. Income Support, Incapacity Benefit) and replace it with a Universal Credit to be phased in from 2015.
- (iv) The Coalition has also indicated that it will allow authorities to end the current system of security of tenure and replace it with short-term 'flexible tenure' contracts, where applicable, for new tenants.
- (v) The Minister has also announced that he proposes to create a new 'affordable tenancy' for housing associations based on a rent of up to 80% of the market rent. This will be available for associations to charge to re-let tenancies and newbuild properties.
- (vi) The Coalition has earmarked £4.5bn for new housing over the period of the spending review, including existing commitments. The government plans to deliver 150,000 new affordable homes over the next four years through a combination of additional borrowing raised from the additional income from the new higher 'affordable tenancies' and grant from the remaining pot. This represents a significant move away from supply-side subsidies to demand-side
- (vii) The Minister has also announced that he will change the planning system to enable local communities to deliver more housing through a 'New Homes Bonus ' worth £1bn which will allow authorities to retain council tax income from any new units built rather than it being recouped.
- (viii) Associations, like other non-public bodies and individuals, are having to incur increases in VAT to 20 per cent.

Whilst the government has set an ambitious target of 150,000 new homes (including those in the pipeline) it remains to be seen whether the fundamental shift away to demand side subsidies will deliver sufficient new homes, particularly if the government plans to reduce housing benefit in the medium term and at a time when the role of the regulator is being reduced. Associations and lenders will want to scrutinise business plans in a lot more detail if significant borrowing is being secured against these higher rents.

The council housing reforms may present more opportunities for councils to build but will depend on any associated borrowing controls. Other options may be preferable. Changes to the security of tenure and rent levels might have different impacts depending on how tenants and landlords respond, although any additional income generated could be used to deliver additional homes.

It is not clear whether the new planning proposals will help deliver more new affordable homes. If it is not combined with grant or the release of public land it may not. Cuts in grant will inevitably reduce the number of homes delivered as will any extra costs associated with VAT for example.

Scotland

The Scottish model of providing housing is similar in many ways to that used in England with demand-side subsidies provided to tenants and supply side capital grants to housing associations and supported by loans from banks and building societies. The subsidy system for local authorities is different, however, as there is no clawback of surpluses from low debt authorities.

The method of funding new housing in Scotland has to some extent already been the subject of more detailed scrutiny and is informative for the wider policy debate in the UK and England in particular.

Immediately prior to the credit crunch in 2007, the new SNP Scottish Government produced *Firm Foundations*, a housing policy platform including a target of annual new supply of 35,000 units (an unspecified proportion of which would be affordable/social) compared to the typical annual level of 20–22,000 completions. At the same time the Government intensified a drive to reduce the cost of development and in particular the subsidy per unit (then averaging over £70,000). In large part, this was to be achieved by lead developers (regional consortia bidding for multi-year Housing Association Grant programmes and seeking significant scale economies. The national housing lobbies argue that Scotland requires around 10,000 units of social/affordable new build for several years to address unmet need. Government clearly at the time pinned a lot of hope on Section 75 planning agreements (the relatively new and emerging Scottish equivalent of Section 106 agreements in England).

The recession and credit crunch severely dented Government aspirations (for instance stopping Section 75 affordable output in its tracks). The policy response involved:

- Accelerating public finance by bringing forward capital from year 3 to year 1 and 2. This fact, plus the contraction of build for sale, allowed a record year for social housing development in Scotland of more than 7,000 units all-in for 2009–10. But next financial year is the 'black hole' year, plus a considerable volume of forward funding has been done, mortgaging a significant part of the capital programme through commitments already made. The Government also made a case for further funds 'accelerated' from the next Comprehensive Spending Review but this was firmly rejected by HM Treasury.
- Proposals to encourage lead developers were watered down but government grant per unit assumptions are reducing the grant available and consortia of developers are being encouraged and supported. Proposals outlining how mid-market rent would work in Scotland have been added to shared-equity models for new supply and off the shelf housing.

- Abolition of the right to buy (RTB) on new build social housing, followed, in the current legislation of the RTB for all new tenancies. This was partly driven by the need to encourage councils to build new general needs housing. This has been further enabled by three waves of grant assistance (up to £25–£30,000 per unit). As a consequence, the first two waves of schemes leveraged out of £50 million of Government funds will generate 2,297 units with a third wave bidding process currently open funded by a further £75 million. The council programme uses combinations of government grant, capital receipts, prudential borrowing and council land.
- East Lothian Council has entered into a partnership with East Lothian housing association where after a successful pilot, the council (because the council has the financial capacity) decided to both build 1,000 council houses over a five-year period and intend to act as the source of long-term finance for the housing association (£15–25 million). In neighbouring Midlothian Council, the local authority intends to develop 1800 homes for rent and sale; 1,000 new council homes, and the rest developed by housing associations (CIH, 2009). The key to unlocking this potential in both cases was low debt, high demand, potential rent growth because of relatively low rents and the potential headroom for prudential borrowing available in both councils.
- The Scottish Government (as part of a UK deal) also helped secure a large tranche (£50m) of private finance through the European Investment Bank (EIB) in 2009. However, this funding is limited and unlikely to be available in future on a regular basis for social housing funding.

The recognition of the difficult forward public funding context leaves the Scottish government seeking fresh alternative approaches to packaging new affordable and social housing finance. A new housing bill is promised in 2011 that will focus on financial innovations and is thought to be willing to explore several new ways forward. It is expected to explore further co-operation between councils and housing associations, a greater potential role for the private sector in delivering and equity-funding social housing, and a single affordable housing grant funding regime for both councils and associations (probably to the latter's detriment in terms of per unit subsidy).

The Government is also seeking to establish a National Housing Trust that will enable local authorities to expand mid-market rent affordable housing. This will be funded by 65 per cent PWLB with the balance coming from the lender or developer who set up Special Purpose Vehicles (SPVs) aimed at unsold, partly built or planned new housing. The Government guarantees the council for any repayment or capital shortfalls over the ten years of the programme (before assets can be realised through sale). According to the Scottish Government (2009, p1): "It involves setting up a new vehicle – the NHT – to facilitate the purchase of homes by Special Purpose Vehicles from lenders or developers – these could be part built, built but unsold or not yet started. The advantage to developers is that there is a known customer for the built homes

which allows them to raise the working capital to continue or restart their development. The public sector does not carry any risk during the development phase and can choose sites which match local housing need and demand, both in terms of type of home and locations.”

Further ahead, the recent Calman Commission on Scottish Devolution, recommended devolving housing benefit, and, they have said they would devolve stamp duty revenues to Scotland. Both such moves could present important revenue streams for policy-makers seeking more radical approaches to work with in future.

The recent Scottish housing policy discussion document *Fresh Thinking, New Ideas* published in May is a pragmatic analysis that looks for new ideas to boost affordable supply (Chapter 2) and this includes many of the ideas discussed in this section which draw on ideas seen abroad: e.g. national housing banks that act as conduits for finance, the securitisation of equity held by social housing providers and loan guarantees against losses. The lesson from the Scottish Government's paper and the discussion above is that there is no ‘magic bullet’ but there may be several initiatives that the UK can learn from. Suitably modelled for our housing and financial system, this may offer ways to boost resources for affordable housing or at least improve terms and conditions.

The impact of the credit crunch on the funding of new social housing

There have been a number of direct and indirect impacts on the social housing sector arising from the credit crunch. Some of the key impacts have been as follows:

- (i) The first and most striking impact was the loss of confidence in the Inter Bank lending market which initially resulted in a shortage of credit being offered. A further consequence of this was a steep increase in lending margins in the housing association sector above the very competitive market rates which had prevailed in the sector for many years prior to that. Tied to that was a desire to revisit existing lending agreements – especially where associations were in technical default on their loan covenants on issues which would generally have been overlooked in a more accepting market.
- (ii) Combined with this was the significant knock-on impact on the housing market/land prices and an initial stalling on housing developments. This had a major impact on developers but also on associations that were working on mixed developments where some of the social housing, particularly on larger sites, was being cross-subsidised by private development.
- (iii) The crunch has reduced the availability of credit, but crucially also the terms and conditions of credit and this may also impact on existing loans if the price of agreeing a new loan as well as the risk of a technical default on existing loans. This has led to some housing associations becoming more risk-averse and having to manage their assets, their reserves, rent arrears and voids and their cash flow ever more carefully.
- (iv) Whilst a recession, higher unemployment and indeed repossessions may lead to a significant increase in the demand for social housing, further evidence needs to be gathered on this – since much may be displaced into the now larger and growing private rented sector.
- (v) The credit crunch has demonstrated the pro-cyclical nature of the mixed funding and cross subsidy model based around associations developing for sale. It would suggest the need for a more sustainable but conservative long-term model – particularly for larger sites.
- (vi) As indicated above the Credit Crunch has clearly had major real economy repercussions on the development side in terms of the construction sector, working in partnership with private developers (S106etc.) and on the land market. The extent to which councils

The ability of the public sector to address the need for additional affordable housing will still be dependent on public funds to a large extent and this will be dependent on how those funds are targeted. Whilst there was an acceleration of public funding initially both in Scotland and in England as a response to the credit crunch, Coalition Government has made significant cuts in social housing grants.

Whilst confidence in the property market was building up again and lending margins have decreased below their very high peak, neither is anywhere near where it was previously and recent evidence suggests that building programmes are stalling in some places with uncertainty in the local sales market and will be affected by the continuing uncertainty across Europe. The consequence is that it is more risky and still more expensive to enter into development contracts than it was when the market was buoyant. The knock on effect has been a reduction in the amount of social housing delivered through s106 schemes (section 75 in Scotland). As highlighted above, the cost of borrowing – relative to Base Rate and LIBOR – is also much higher.

The main focus of social housing delivery since the onset of the credit crunch and associated economic problems has tended to be on smaller sites primarily if not uniquely focussed on social rented housing, where grant has been accessed.

Whilst there may be scope to deliver more social units on some larger sites there has been a reluctance within the HCA and indeed local housing/planning authorities to build large monolithic single tenure estates and repeat the mistakes of previous decades. Consequently there has been a renewed focus since the credit crunch on smaller sites that may not be able to deliver the same economies of scale as some of the strategic sites previously targeted by the HCA and local authorities.

Setting aside the issue of the size of the sites and the related problems the other key issue which the credit crunch has helped highlight is the lack of affordable housing for those who do not have access to social housing on the one hand but are priced out of the market at the other end of the scale.

It could be argued, in hindsight, that the credit crunch was a predictable outcome of the wider problems that we have had in the housing market more generally within the UK and that some form of local as well as global adjustment was bound to happen as a consequence of the way that lending decisions were being made.

In this sense the problem was not so much the credit crunch itself but the system that allowed the credit crunch to happen.

Whilst there were undoubtedly other contributing factors which were a cause of the credit crunch, the lending decisions to private home-owners, the wide availability of credit and the subsequent offloading of 'subprime' mortgages across the financial sector were obviously major factors.

In the UK the reduction in social rented accommodation over the last two decades (and more) at a time when the population has continued to increase will also have been a factor as this may have led some people towards home-ownership in the belief that they had to get onto the housing ladder. If the supply of available (social) housing was higher in some areas some people may otherwise have chosen a different tenure model. There is therefore an argument that house prices might not have escalated in quite the same way and there would have consequently been less volatility in the market.

Alternative international funding models

While there is no scope to provide a comprehensive review of international models that might offer something of value to enhance new social supply in the UK, it was possible to outline a small number of key ideas that might have wider currency. This short overview has been guided by Whitehead and Scanlon, 2007; Gibb and O'Sullivan, 2009; and Chiquier and Lea, 2009;.

National housing and welfare contexts are of course important to understanding different forms of subsidy, financing and pricing of social housing across Europe and beyond. Any inference from comparative study needs to be made carefully though that does not imply that there are no lessons to learn or apply in a UK setting. But, as Whitehead and Scanlon observe (2007, p.85–6), different rent regimes are imposed more or less from central government and these will have a direct impact on the capacity of landlords to build reserves, invest in their assets and for private funding to come into play. Whitehead and Scanlon note no obvious pattern of convergence on rent setting regimes across Europe. They do however denote broad trends: shifts away from supply-side to income-related subsidies and from subsidy to debt finance and from subsidy to contributions from other parties such as developers and landowners but also employers. They also detect growing interest in private equity either through PP/PFI partnership arrangements or through direct purchase (p.93).

Debt finance in many European countries has been used to provide new investment with privatisation often adopted to capture the equity value in more mature housing as further collateral (Whitehead and Scanlon, 2007, p.88). Reliance has been on special circuits adopting public borrowing or subsidised and sometimes as in Holland, France and Sweden to state backed (or indeed mutual funds, as in Holland) borrowing through loan guarantees (Gibb and O'Sullivan, 2009).

On the equity finance side Whitehead and Scanlon point to the recycling of assets through sales to tenants, the use of unencumbered assets, both houses and land, the explicit use of accumulated reserves and cross subsidy (though much of this activity has been in the UK and England rather than in Europe!). They do also point to the importance of Community Land Trusts in many countries such as Germany (also discussed in Chartered Institute of Housing, 2009). In their survey of social housing, only Germany so far provides evidence of large scale private sector equity involvement via privatisation sales of municipal housing in places like Dresden in the East and through partial transfers in the west (2007, p.90). Under such models: 'A license is specified, clarifying the conditions under which tenancies are to be provided, including how rents may be set, when evictions may take place, etc. It also clarifies the rights of the new owner to sell properties, demolish and redevelop them, and their responsibilities with respect to management, maintenance and improvement. These conditions help to determine the price at which the properties are sold – so there are difficult incentives/disincentives when determining the license' (p.91).

Whitehead and Scanlon also look at the nature and range of subsidies used in Europe. Probably, with the exception of France, public subsidy is in retreat or at least there is a search for alternatives. One key alternative is land – either offered by public landowners at below market prices or through various forms of contributions made by landowners and developers more generally – something very familiar to the UK. Several countries continue to use cheap public sector land because, if the ownership of land is not transferred in some form of partnership arrangement, it does not show up in public accounts. This is also important in regeneration projects in countries like Holland, Denmark, France, Germany and in England too (Whitehead and Scanlon, 2007, p.92).

Are Tax Increment Financing (TIF) vehicles relevant or useful here? Can they encourage or enable more social housing to be built in new mixed developments? Proposals in Scotland for the regeneration of the former steelworks at Ravenscraig involve TIF funding to support the overall package of mixed use development, dominated by 3,500 homes, a proportion of which are to be affordable and socially rented.

Le Blanc et al. (2009, p.382) examine recent models of capital financing of residential renting projects from an emerging markets perspective. They distinguish between residential commercial mortgage-backed securities (MBS) made by banks for rental investment (e.g. the Finnish ARA who have used transactions similar to commercial MBS to sell parts of their social housing portfolio loans); direct financing of a rental project by bonds with or without the backing of a non-bank financial intermediary (e.g. as with large group structures in the UK and most Eurozone countries increasingly rely on market-based instruments, with the exception of France and Austria); and, the issuance of bonds by local authorities, the proceeds of which are lent on to rental projects (as with municipal tax-exempt bonds in the USA, which also involve competitive bidding procedures for projects financed by housing tax credits).

Four European examples of securitisation (Le Blanc et al., p.384) are:

- Sweden. The city of Gothenburg sold a number of social housing loan portfolios originally used for low-cost multifamily rental housing to an SPV that raised funds on capital markets.
- Finland. Funds were raised in the asset-backed capital markets by the sale of multifamily social housing loans by ARA.
- Belgium. Loans made to social housing companies for low-cost provision were securitised.
- Netherlands. Securitisation of loans to Dutch housing associations in the late 1990s guaranteed by a specially established state entity.

Le Blanc et al. argue with respect to direct capital market issues by social landlords (chiefly in the UK) that UK housing associations as undiversified social providers are countercyclical businesses (whereas wholesale funding is pro-cyclical) – thus efforts to diversify funding stream including capital markets and long term bank debt ‘should be considered prudent’ (p.385 footnote 15).

US affordable housing is provided through a package of federal and state programmes, normally augmented by funds from third sector institutions (Le Blanc et al., p.388). A development once approved by the relevant agencies can become eligible for state credits once it is approved for federal credits. The two key federal tax code subsidies are: first, the low income housing tax credit which can be used directly for their 10 year life by a borrower and would offset borrowing costs by reducing tax liability or it can be syndicated (i.e. sold) to generate part of the equity needed to make the project work. "The developer sells the tax credits to a private investor (both individuals and corporations) through a process known as 'syndication'. A 'syndicator' is an organisation that helps set up a partnership between the developer and the private investor to co-operate on tax-credit projects... The developer's capital thus raised will be paid through the syndicator's equity fund in stages." (Le Blanc, et al, pp388–89). Second, local governments can issue tax exempt bonds for the financing of affordable rental housing provision. Le Blanc et al. estimate (p.389) that between 1995 and 2005, more than 1.1million units were constructed under the LIHTC programme (30 per cent of all multifamily rental construction). At the same time the investor market for tax credits has grown larger and returns have improved to investors.

Germany equity involvement in the privatisation of former East German housing estates presents mixed evidence. The German experience has not always been a particularly happy one with several instances of the re-sale by the original purchaser, continuing problems of low demand, maintenance and management in dispute with tenants. Early deals appear to have been exposed by the global financial crisis and it is not obvious that the model is transferable to the UK.'

There are common themes apparent in this brief and partial examination of other countries' experiences. There is a shift away from supply- to demand-side subsidies, along with increasing interest in expanding the role of private finance (broadly conceived) in the development of new affordable housing and the re-financing of existing stock.

A further common theme impacting on this analysis is the vast array of different institutional models for housing finance, property law and the profile of the main providers. For instance, in Australia the sector is dominated by public housing at state level. Until very recently there has been no third force of community or voluntary housing and limited scope for innovative urban social housing in Australia.

The balance between the amount of funding across different nations through demand-side support (in the form of personal subsidies) in contrast with the supply-side support (through capital and revenue subsidies including free or discounted land) presents a mixed picture overall. Whilst there are some lessons to be learnt (which we refer to below) there needs to be more detailed research to establish which systems have dealt best with the impact of the credit crunch and associated market volatility.

Near-market renting

As highlighted above, the extremes of the credit crunch have helped to demonstrate one of the problems with the way the current property market works, in the UK, as well as in various countries abroad, in that it still tends towards a short-term 'boom and bust' cycle – even when inflation within other parts of the economy is more stable.

In order for the overall housing market to work more effectively, there needs to be greater long-term stability on property prices combined with a more sensible long-term view on lending. There also needs to be a more effective way of providing support to people at different stages of their lives through the subsidy framework.

Given the difficulties with the operation of the housing market and the lack of an effective intermediate market, one idea which we were asked to explore further was the idea of 'near-market' renting. This has been taken over to some extent by recent government announcements for the new 'affordable rent' based on 80 per cent of market rent and as highlighted already will have different consequences across the country. Initial analysis indicates that this isn't a model which has been readily used abroad in this format.

As highlighted earlier, anything which is considered to be sub-market must, by definition, be receiving some form of subsidy either from the landlord or another public source or benefactor/philanthropy. The government's expectation is that the social landlord will significantly rely on cross-subsidy from the higher income generated from re-lets of some existing social tenancies.

Beyond this the issue about near market is where would one set it in relation to the market, how might it be varied at a local level, what form of subsidy would be used in order to maximise the benefit the subsidy provided and at whom would it be aimed:.

- (i) Target audience for 'near-market' housing – the first issue to be addressed is who might the subsidy be aimed at and at what level. If the intention is to provide access to people who are employed currently but cannot quite afford private rents a 'near market' rent might be set at around 5– 10 per cent below the current market may help to make a difference and help activate the market.
- (ii) The next issue would be how this subsidy might be paid and in what form. If it were paid directly to the landlord (or from the landlords' own resources) it could be paid as a periodic rental supplement (e.g. monthly) or as an up front premium. If it were paid as a capital grant there would need to be some form of agreement as to the future use of the dwelling to which it related. In either case there would need to be some contractual arrangements put in place to ensure the subsidy was being effectively targeted and properly spent.

- (iii) An alternative would be to make the payment directly to the individual as some form of rental allowance – possibly linked to some form of means testing. One of the issues here would be how it is administered (e.g. through local housing benefit office or an allowance against income taxes perhaps).

Whilst this would no doubt help stimulate certain parts of the rental market the question is whether this would be sufficient in itself to bring about fundamental changes and there would need to be greater clarity on how and why certain audiences were targeted.

This naturally leads on to the wider question of how the intermediate market is best catered for given the differential between the social and private rented sector particularly in high value places such as London and the South East.

The Coalition Government has started to challenge some of the conventional wisdoms surrounding the provision of subsidies towards new affordable housing, the level of rents, the form of tenancy and how it is allocated. The pace of change suggests that these new arrangements will be rolled out across the country without significant testing and that landlords will be given flexibility at a local level to implement them.

For the last decade and more, the main source of subsidy towards the 'intermediate' housing market has been met through Shared Ownership on the assumption that people wanted to get a step on to the housing ladder. For people on low incomes who could not get access to social rented housing there has been extensive use of the private rented housing in some areas. Recent limitations on local housing allowances paid to private tenants has had various knock-on impacts and in some cases may result in people having to move out of the more expensive areas. In London and other high value urban areas there has also been a tendency towards increased house and flat sharing in order to keep housing costs down. This has led to significant overcrowding in places.

The effect on the intermediate market of the credit crunch and its consequence is still largely unresearched and would justify further analysis at a national level in order to take a view on whether a fundamental change in the way housing is subsidised.

Some research into housing needs will have been carried out by authorities at a local level to ascertain how the market operates within individual areas – particularly where access to social housing may be most difficult and this will need to be updated to take account of the new government proposals. In order to justify a more radical approach to public funding of social housing there also needs to be some further research undertaken into existing social tenancies and how changes in financial circumstances have affected housing choices and their ability to pay more than existing social rents. To some extent this has now been overtaken by events with the government's radical agenda beginning to emerge. Whilst moving to a demand-side subsidy

system based on near-market rents will produce some new properties, it will still require some additional subsidy to work effectively and will, in the short run, result in an increase in benefit costs. How authorities in their strategic role and landlords respond will depend on the operation of the market in their local area. If the overall benefits bill is to be reduced a key issue will be how affordable these new forms of tenancy might be when the full benefits changes are eventually introduced and how this impacts on local choices.

Conclusion

There has been a net reduction in social rented housing across the UK over the last two decades (and more) of over 0.6m units at a time when the population is increasing and household formation demands are changing. Whilst this loss of units has partly been met by the introduction of shared ownership and other sub market products, the net reduction in supply loss is still considerable and has arguably contributed to the escalation of house prices and the resulting market volatility. This made the UK market, like many others countries, susceptible to the financial difficulties arising from some poor lending decisions across the globe and the resulting trade of those 'assets' particularly from the US.

The system adopted in the UK of a mix of demand- and supply-side subsidies has not in itself created difficulties but the lack of any challenge to the existing system at a national level when social housing supply has been decreasing has not helped.

International experience is not conclusive with regard to the most appropriate system of subsidised housing as much depends on inter-related factors including the inter-related nature of rent and benefits policies, different institutional models, the relative levels of demand and supply for housing generally at national and local levels and general economic conditions.

However, what is clear is that there needs to be a more co-ordinated assessment of how new affordable housing might be delivered. The recent increase in house prices has once more plateaued following the previous steep decline in 2007/08 and current indications are that the market may be facing a further structural reduction. This has been matched by the recent further fall off in house building.

A further structural reduction in prices will help to make housing more affordable, particularly in some regions, but the argument for more affordable housing remains strong and would provide a fillip to the construction industry in the meantime.

The big issue remains how to deliver those additional units when public finances are constrained and grant funding limited. A number of areas have been explored in this paper particularly around the use of existing assets and would warrant further investigation as follows:

(i) Use of hidden equity in local authority stock

Despite the wider concerns about public sector debt, the level of housing debt in the local authority sector is actually relatively low at less than £10,000 per unit. The proposed Council Housing reforms will give authorities some additional flexibility particularly in the long run but if this is accompanied by borrowing caps and other limitations (e.g. caps on benefit subsidy) then the short-term opportunities are limited. One option would be

to adopt the Gross Government Financial Deficit (GGFD) approach to public sector accounting as used abroad. However, in the absence of this more widespread change an alternative avenue would be to adopt a separate approach specifically to social housing and transfer the existing 1.8m assets to a new type of vehicle which could use those assets for extra leverage to support new build. Combined with a further drive to deliver more value for money efficiencies from the sector (e.g. through better repairs procurement, shared services, etc.) this could provide some extra resources.

(ii) Use of public sector land

One of the most significant but underutilised set of assets is the land owned by local authorities and other public sector bodies. Much of this does not generate a return at present and a more co-ordinated – and more incentivised – policy approach to this would help release the resources that can provide the additional subsidy for new affordable housing. This goes beyond the Coalition's strategy of allowing authorities to retain council tax income on new housing. Ideally it would be co-ordinated with (i) above providing the extra asset base with which to support new borrowing.

(iii) Alternative sources of borrowing

The introduction of mixed finance enabled lenders, mainly in the form of banks and building societies, to become key players in delivering new build over the last two decades to the housing association (HA) sector. However the credit crunch has meant that lenders are no longer providing finance at the low margins which have been previously enjoyed across the sector (despite the absence of any bad debts). A more radical look at alternative sources of borrowing to complement the capacity within the sector would help generate better value for money. In the absence of direct lending from the state via the PWLB, other options might include more focussed lending products from the state owned banks, greater tax incentives for pension funds or private equity investors or the reintroduction of guarantees or local authority bonds targeted at specific lending projects – and leant to the new vehicles as appropriate.

(iv) Rents and benefits reform

The new Government has already decided to focus on switching from supply-side subsidies (in the form of capital grant) towards demand-side subsidies through increasing rents on re-lets and newbuild units. Part of its overall plan is to reform Housing Benefits and introduce a Universal Credit to replace all benefits to be phased in over two parliaments. There had been some concerns regarding the recipient of the housing element of future benefit payments but the government has sought to reassure landlords that this would continue to be paid to landlords.

The government's proposals to let housing associations charge higher rents for the new category of 'affordable tenancy' will have a mixed impact

across the country. In some parts of the country 80 per cent of the market rent is quite close to the existing social rent as land costs are quite low. In these cases there may be a need for more grant to produce more homes. In London and the South East higher rents will generate additional rent income to support additional borrowing. However much will depend on who these properties are allocated to, and as noted above, if benefits are reduced over time this may not generate as many new homes as the government hopes.

There have been no specific proposals yet to allow councils to use alternative rent structures, but if there are, this may require new legislation to define properties to be held in the HRA as these are currently prescribed under Part II of the Housing Act 1985. The new arrangements may also have an impact on the charitable status of associations and their associated tax positions.

(v) Further efficiency and rationalisation within the HA sector

The growth of the HA sector over the last two decades has been driven by development and stock transfer. If there are fewer opportunities to grow via transfer and with grant rates being cut then developing HAs will need to look at other ways of delivering efficiencies to support new build. As with LAs there may be ways of delivering this through better procurement and shared services. There may also be other ways e.g. making VAT savings through setting up a local Direct Labour services organisation. The other key way to create more equity in the combined HA balance sheets and deliver extra resources is through merger, takeover and stock rationalisation – which will become ever more important in the absence of stock transfer. At the moment this is largely driven by the HAs themselves though the role of the regulator, in whatever guise this might be, will also be important.

(vi) Other grant/borrowing sources

In the absence of direct grant funding from the UK Treasury or borrowing from the PWLB, other sources could be sought including the EIB, as used in Scotland, although the likelihood of this becoming a major source of funding seems remote.

This paper has sought to highlight some of the different ways in which additional new housing supply might be delivered as a way of combating the combined impact of the credit crunch and the associated wider housing market volatility. The arguments for and against the different forms of subsidy remain. The new Coalition Government seems focused on reducing supply-side subsidies in the short term and demand-side subsidies in the longer term. A key issue going forward will therefore be the use of existing assets and altering the existing institutions and regulations within the system where appropriate to deliver those extra resources.

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