rhetoric to reality:

a report on affordable housing prospects in an age of austerity

By Andrew Heywood

THE SMITH INSTITUTE

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Foreword
Paul Hackett, Director of the Smith Institute

The Smith Institute has been at the forefront of the policy debate on the future of affordable housing. This report maintains that momentum and provides a timely and important perspective on the challenges facing the sector. In advance of the spending review and against the backdrop of the government's housing and welfare reform agenda, the report looks at what lies ahead for social housing landlords. It examines the costs and consequences of cuts, considers new funding options, and calls for a pragmatic policy response based on market realities rather than wishful thinking.

The report is based on research into the changed market for affordable housing, one-to-one conversations with leading experts and practitioners, and two high-level round table events at the Smith Institute involving politicians, commentators, funders, developers and representatives from across the housing sector. Of course, the observations and conclusions reached in the report do not necessarily represent the views of everyone we spoke to. However, we are most grateful to all who attended the round tables and to those who have submitted comments.

We would like to give special thanks to Andrew Heywood (independent consultant, editor of *Housing Finance International* and visiting fellow at the Smith Institute) for writing this report and to Home Group for supporting the project.

Executive summary

Executive summary

This report argues that without determined joint action by government and housing associations to develop a new funding model, provision of affordable housing will reduce progressively over the medium term. Open-market sales can no longer be relied on to subsidise general-needs housing development, keep grants low, and support home ownership. The government must recognise that the mixed funding (cross-subsidy) model that has underpinned housing association investment for more than 20 years is broken.

Housing in crisis

Despite the government's pledge to build more homes and help 1.4 million households that cannot currently gain access to home ownership, the prospects for affordable housing development are at their worst for a generation.

The affordable housing sector is in crisis, and without new solutions for affordable housing there is a real risk that the government's housing aspirations will meet with bitter and damaging disappointment.

Housing in England faces unprecedented challenges: the lowest level of house building for 60 years; 1.8 million on housing waiting lists; average house prices at six times annual earnings; and mortgage funding constraints whereby first-time buyers need deposits of 20%-25%.

The government's plans to cut public spending will make matters worse. Significant cuts in grant for affordable housing will threaten the ability of housing associations to fund and build new homes for rent and sale. The funding famine will be compounded by reform of housing benefit. Sharp reductions in housing benefit will seriously threaten private funding flows to housing associations.

Abolition of the Tenant Services Authority and weakening of the regulatory regime could also increase costs for both housing associations and the government. The rise in VAT is also likely to hit housing associations hard.

Housing associations in an age of austerity

The preconditions for the functioning of the cross-subsidy model of development by housing associations have been swept away. Open-market sales can no longer be relied on to subsidise general-needs housing development, and offer a viable home-ownership opportunity to a swathe of lower-income households outside a limited number of localities.

Confidence and appetite to build among housing associations are at a low ebb, and have been for some time. (Future development prospects were already grim before the election.) The combination of spending cuts, housing benefit reform, and a weakening of regulation could devastate the sector.

Given the bleak outlook, there is an urgent need to identify new solutions, and to rethink the mixed funding model that has underpinned housing association development strategies for over 20 years.

New solutions

Housing associations are in a strong position to work with government to identify new solutions. They have access to private finance at advantageous rates, significant unencumbered assets, and a good track record. Their borrowing is also off the public balance sheet.

The issue, however, is not one of access to private funding; it is the absence of a viable development model to which that funding can be applied. This situation existed when the coalition government took office, but could get worse.

There is a need for a new agreement (under the auspices of the upcoming spending review) between government (and its agencies) and housing associations to bridge the funding gap. Housing associations can commit to improving efficiencies and new models for development. Government can offer programme certainty, public land for development, a greater degree of rent and asset management flexibility, and a clearly defined housing element in housing benefit paid to landlords.

Mitigating actions

Housing associations' confidence to develop remains low and has been eroded by government's recent announcements. However, the forthcoming spending review offers an opportunity for government to create a more positive relationship with the sector. Government could take the following actions to mitigate the crisis in affordable housing:

- offer incentives to shift development away from general-needs and low-cost home ownership towards market renting, with the aim of maximising the build rate with minimum grant;
- allow greater rent and service charge flexibility – allowing social rents to rise in order to cross-subsidise future development;

- ensure that any reform programme for housing benefit provides for the continuation of some form of stable and reasonable housing allowance paid directly to landlords;
- recognise the role of sound regulation of HAs and local authorities in securing private funding at low rates and ensuring that the Homes & Communities Agency, as successor to the Tenant Services Authority as regulator of the sector, has the necessary focus on financial viability and governance, possesses credible enforcement powers and has adequate resources; and
- enable local authorities to fulfil their potential to secure investment for development and examine the case for government to use international standards to reclassify public borrowing.

Social costs

Even if a decline in development is mitigated, there will be a price in terms of the social consequences of change. There will almost certainly be less general-needs development, which will affect people in work on low incomes.

A move towards higher rents and more market renting will also make any transition from benefits to work more difficult. A lower-grant environment will also increase reliance on local markets and mean less needs-based strategic planning. Other social housing objectives, such as the creation of mixed communities, may also be at risk.

The government and the affordable sector must fully recognise these social costs and strike the right balance between helping those in most housing need and finding alternative means of supporting development in a period of austerity. Ministers should ensure that, in the search for new solutions, rhetoric does not become a substitute for effective policy making.

Chapter 1

The way we were

The way we were

The Owl of Minerva spreads its wings only after the falling of dusk.
GWF Hegel (1770-1831), in the preface to Philosophy of Right (1820)

Affordable housing providers inhabit a changed world when compared with that of the period prior to the banking crisis that erupted in 2007. The economic outlook and policy framework have been transformed, and the prospects for future affordable housing development have changed almost as radically. The affordable housing sector is now squaring up for the next comprehensive spending review. The sector has seen cyclical downturns before, and severe but temporary cutbacks in government support, but the scale and combination of economic, financial, and fiscally driven factors now faced are almost unprecedented.

A convenient benchmark for evaluating change is the *Pre-Budget Report & Comprehensive Spending Review* published and debated in the House of Commons in October 2007.[1] The banking crisis had first hit public awareness the previous month, with the failure of Northern Rock, but its implications had not yet become apparent to either the public or policy makers. Largely prepared over the previous year, the review can be seen as the high-water mark of an affordable-housing development paradigm that was shortly to crumple under successive financial and economic shocks.

Prior to 2007, the affordable housing sector – centred on housing associations (HAs) and featuring a mixed grant/private finance model – had seen almost two decades of continuous growth. Choosing a historical starting point always courts controversy but the Housing Act 1988 can be seen as such an event. In important ways, the Act put in place the planks on which the edifice of affordable housing development would rest going forward and which are still fundamental.

Among its provisions, the act:

- modernised the grant regime and allowed HAs to combine grant with private finance;
- allowed development risk to be borne by HAs;
- enabled lenders to take a first charge over HA assets and subordinated public grant to that first charge; and
- made possible the continued availability of housing benefit to cover rent payments as needed.

1 HM Treasury *Pre-Budget Report & Comprehensive Spending Review* (2007)

Add to this the progressive development of Housing Corporation regulation that provided (and continues to provide, under the auspices of the Tenant Services Authority or TSA) private finance providers with reassurance that they could rely on minimum standards for and on-going scrutiny of the governance and financial viability of the HA sector, and the key elements of the funding regime for affordable housing were in place. Clearly, the benefits of planning gain have contributed, and will continue to contribute, towards affordable development. Planning issues are beyond the scope of this paper, however.

Progress was initially modest. In 1991, during the last recession, private finance totalled around £1 billion. By 2007, according to TSA estimates, drawn-down private finance facilities totalled around £34 billion, with accumulated social housing grant standing at around the same figure. Since then private finance has overtaken grant as the primary source of accumulated finance, and private finance facilities in England are estimated at around £59.4 billion.[2]

With the benefit of hindsight, the 2007 spending review[3] can be seen as a testament to the retrospective nature of human understanding. Its tone is upbeat and expansionist, the looming banking crisis is dismissed as a slightly distracting example of "financial disruption". Public spending was set to rise from £589 billion a year in 2007/08 to £678 billion in 2010/11; an annual rise in real terms of 2.1%, as the review proudly states. This was underpinned by growth predictions that emanate from another world, or at least another mindset: 3% for 2007, rising to 2.5%-3.0% for 2009 and 2010.

For those concerned about the golden rule (that current spending should not exceed tax revenue over the course of a complete economic cycle), there is reassurance: "The current Budget shows an average surplus as a percentage of GDP over the current economic cycle, ensuring that the government is meeting the golden rule." This fiscal probity provides a firm base from which to offer "further substantial increases in resources for education, science, transport, housing, child poverty, security and international poverty reduction – as well as fully funding the 2012 Olympic Games and Paralympic Games".

While housing did not come out of the review with a settlement as generous as that for education or the health service, the picture was, from the standpoint of 2010,

2 TSA estimates
3 HM Treasury, op cit

distinctly optimistic. Housing spend was to increase from £8.8 billion in 2007/08 to £10 billion by 2010/11. Local authorities would have real resource growth of 1% a year in real terms over the comprehensive spending review period.

Most importantly, the review confirmed the intentions of the housing green paper published in July 2007.[4] This stated that housing supply would rise to 240,000 a year by 2016, by which time 2 million additional homes would have been produced, a figure that would rise to 3 million by 2020. Of these, affordable housing provision would expand to around 70,000 homes per year by 2010/11. For those with any concerns about mortgage availability, the review was able to state that "the Housing Finance Review launched in July this year … aims to tackle any remaining barriers to the efficient supply of mortgage finance". What a relief.

Predictably, reaction to the Budget was less than ecstatic. *Inside Housing* magazine, under the headline "Darling's Give and Take", opined: "Housing associations will have to contribute hundreds of millions of pounds each year to the affordable housing programme, chiefly by borrowing money from banks."[5] This oblique reference should remind us of a key element in the affordable housing development model that had been growing in importance since at least 2000: cross-subsidy.

From modest beginnings, HAs had been developing shared-ownership properties as part of broader low-cost home-ownership initiatives for some 25 years. By 1992 some 40,000 such homes existed, and over 100,000 had been built by 2007. While both HAs and government were motivated in large part by a desire to promote choice and an aspiration to increase home ownership, the possibility of using the financial surplus from open-market development for sale to subsidise the development of general-needs housing had assumed ever greater importance for HM Treasury. By 2007, cross-subsidy was seen as a way of maximising the output per unit of social housing grant and of cashing in on the apparently perpetually rising property values in the UK housing market.

The use of cross-subsidy was seen as a way of accelerating the decrease in grant levels from around 75% of development costs in the early 1990s to 44% in 2007. The intention to squeeze yet more homes from each unit of grant was signalled in the Housing Corporation paper Unlocking the Door: Delivering More Homes from the Comprehensive Spending Review 2007, a document that can most kindly be described as "of its time".[6] *Unlocking the*

4 Department for Communities & Local Government *Homes for the Future* (2007)
5 "Darling's Give and Take" in *Inside Housing*, 12 October 2007
6 Housing Corporation *Unlocking the Door: Delivering More Homes from the Comprehensive Spending Review 2007* (2007)

Door argued that HAs should gear themselves up further and maximise their borrowing capacity for new development. It envisaged grant levels falling further from 44% to 34% or even lower.

This, combined with the statement in the spending review that "the government will also continue to provide direct assistance to home buyers through shared equity and shared ownership programmes" and with a commitment to expand funding for shared-equity provision, clearly established that cross-subsidy was set to expand over the spending review period.

It should be noted at this stage that cross-subsidy as a mechanism relied on the existence of a viable and resilient mixed funding regime focused on HAs and building on a proven development expertise. Since the Thatcher government of the 1980s, development had been focused on HAs, with local authorities being encouraged to transfer their stock to (mainly newly created) associations. The latter would use these assets to lever in private investment, and transfer would ensure that such borrowing was kept off the public-sector balance sheet.

The mixed funding model itself rests on two vital pillars:

- The first is the existence of housing benefit, underpinning the cash flow of HAs. Housing benefit makes up about 65% of HA rental income. It is seen by private funders as a quasi-government income stream that is effectively inflation-proof, covers the whole rent payable where the tenant is eligible and which is paid direct to the landlord, thus minimising arrears and collection costs. Housing benefit had been the subject of reform proposals in 2002, which involved direct payment to tenants and creation of an allowance based on local reference rents, but these proposals were applied only to the private rented sector following strong representations from lenders and HAs. Though government was known to be keen to reform social-sector housing benefit and to curb the ever-rising bill, no proposals appeared in the period up to the 2010 general election, though a joint HM Treasury and Department for Work & Pensions working group was established in 2008.

- The second pillar on which the mixed funding model rests is the existence of a properly resourced regulator – initially the Housing Corporation but after 2008 the TSA. By ensuring that the risks of poor governance and financial failure in the sector were lessened, regulation enabled private finance to be levered in at levels that would otherwise have been impossible and at rates well below

> those available to any commercial developer. It has been convincingly calculated that the direct costs of regulation have been far more than met by the benefits of cheaper funding for HAs, as interest rates are a key variable element in HA development costs and low interest rates were thus a major factor in allowing grant rates to fall.[7]

At the time of the 2007 comprehensive spending review, the key elements of government affordable housing development strategy could be summarised as a drive to increase affordable housing supply by making the traditional mixed funded development model work harder. In particular, the desire to squeeze the maximum outputs from given levels of grant led to increased pressure on HAs to increase the output of low-cost home ownership (principally shared ownership) and thus to enhance the levels of cross-subsidy of general needs development. It was a strategy that involved increased exposure to housing market risk as well as that associated with increased leverage. Though the latter risks were acknowledged by the regulator and by HAs themselves, it is arguable that the former were not adequately recognised.

This model appeared established and able to deliver on an expanded scale; talk of "sweating" assets was in the air. Whether the model would in fact have been sustainable over the medium to long term had economic and fiscal conditions continued as most commentators assumed in 2007 is a legitimate subject for debate. The real picture, however, proved to be very different.

7 Frontier Economics *Exploring the Costs & Benefits of Regulatory Compliance: Final Report to the Housing Corporation* (2005)

Chapter 2

Recent developments

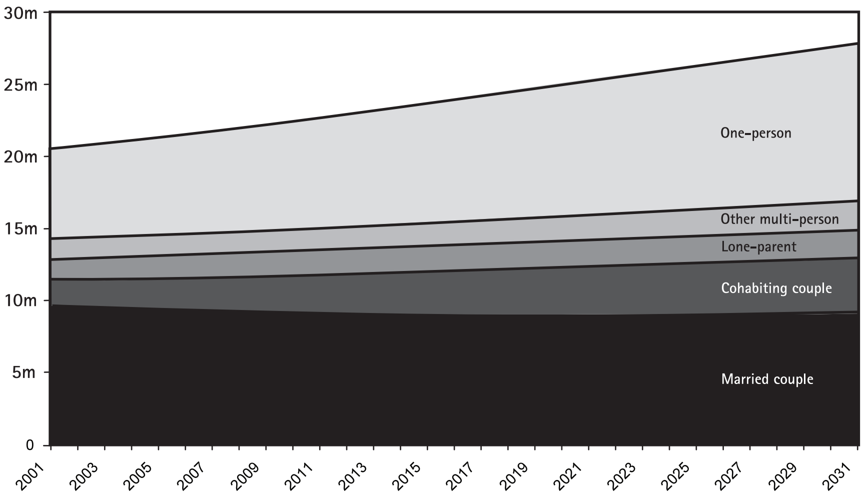
Recent developments

As already indicated, cross-subsidy at a strategic level presupposed three key features of the UK housing market that had been largely unquestioned during the years of growth that followed the early 1990s recession.

Need versus demand

It was believed that there was a fundamental and continuing shortage of supply of housing in the UK and that this would underpin demand for home ownership. This proposition rested on analysis of new-build development rates, set against factors tending to create a situation in which the need for housing outstripped availability. One of the most significant of such factors was the rate of household formation, which showed a projected increase in the number of households, with an expansion in the number of older and single-person households and a continuing drop in the proportion of "conventional" two-parent-plus-children families (see figure 1).

Figure 1: Projected number of households by household type, England



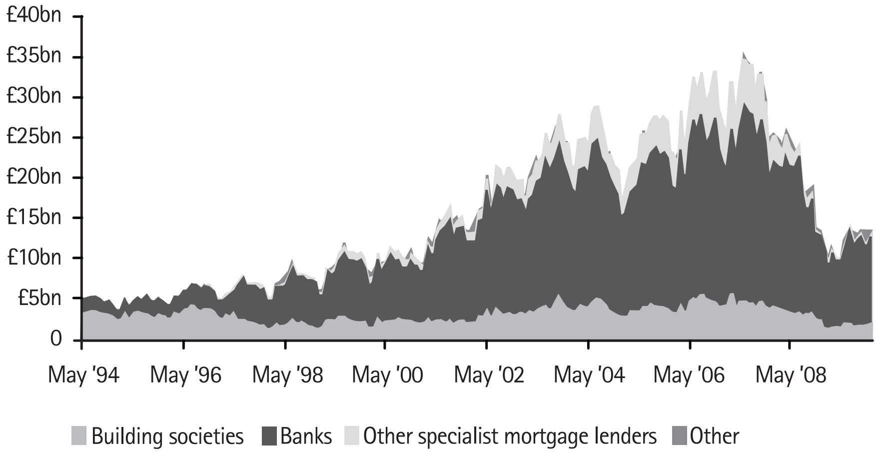
Source: Department for Communities & Local Government *Household Projections to 2031*, England (2009)

With hindsight it is clear that there was here an unacknowledged conflation of "need" for housing with economic "demand". The latter is, of course, not simply a function of need but of the ability and willingness to translate that need into intervention to buy within the market. This in turn rests on factors such as mortgage availability, job security and income, perceptions about the future trajectory of house prices and a range of cultural factors. The distinction between housing "need" and housing "demand" is only now being explored.

Mortgage market contraction

A second key presupposition was that the mortgage market in the UK would continue to facilitate the availability of mortgage finance at low real rates, at high loan-to-value ratios and to a widening cross-section of potential buyers. As figure 2 shows, history appeared to bear this out in the period to 2007, with increasing lending by banks and building societies being augmented by loans from specialist lenders, relying on abundant and apparently liquid funding from the international capital markets.

Figure 2: Gross mortgage lending by type of lender



Source: Council of Mortgage Lenders, 2010

Since 2007 the situation has changed dramatically. Just before the banking crisis, it has been calculated, over 50% of new mortgage finance originated in the capital markets, mainly in the form of residential mortgage-backed securities issued by banks and purchased by investors (most outside the UK). With the onset of the crisis this funding dried up, causing very serious problems of liquidity and erosion of capital for banks and building societies. It also directly cut the supply of mortgage finance, leading to the catastrophic falls in gross lending illustrated in figure 2.

Though the capital markets have since opened to a limited extent, it is unlikely that they will return to former levels, leaving the mortgage market largely dependent on retail deposits going forward. This inevitably means a smaller market in the future. Other factors also militate against a resumption of pre-2007 lending patterns for the foreseeable future. These include:

- the need to refinance government support for the banks – estimated at over £350 billion;
- the lack of the kind of domestic capital markets investor base that exists in other states, such as Germany and the US;
- the regulatory requirement to hold higher levels of capital in relation to lending and to hold more liquid assets, constraining new lending and making it more expensive;
- the need to make provision for toxic loans during a period of economic downturn; and
- new retail regulatory requirements aimed at curbing irresponsible lending, improving risk assessment and better assessing affordability.

While lending has recovered somewhat, the outlook remains difficult. Gross lending remains at less than half peak levels, and forecasts are not optimistic. The Council of Mortgage Lenders has announced that the "risks are on the downside" for its very modest forecasts of £150 million gross lending for 2010, with lending for house purchase in 2010 so far running at lower levels than in the latter half of 2009.[8] Lending by building societies unable to compete for retail deposits has been particularly badly hit, along with that by those lenders previously reliant on the capital markets. The relative market share of the banks as mortgage lenders is now at a record level.

The reduction in lending has been focused on certain groups. Data from the Financial Services Authority suggests that high (over 90%) loan-to-value lending is still contracting, though there is now some availability in the 80%-90% range – albeit at a much higher cost than for lower loan-to-value lending.[9] This differential risk pricing is likely to continue. Sub-prime lending has been particularly hard hit, partly because of the higher risks but also because of the previous reliance of sub-prime lenders on capital markets finance. The lack of capital market funds has also hit buy-to-let lending, though the latter is profitable for lenders and has performed relatively well under recent economic conditions.

8 Council of Mortgage Lenders "CML Warns of Downside Risk on Lending Forecasts", press release, 2 June 2010
9 Financial Services Authority *Mortgage Lending & Administrative Return* for Q1 2010, reproduced by CML statistics (www.cml.org.uk)

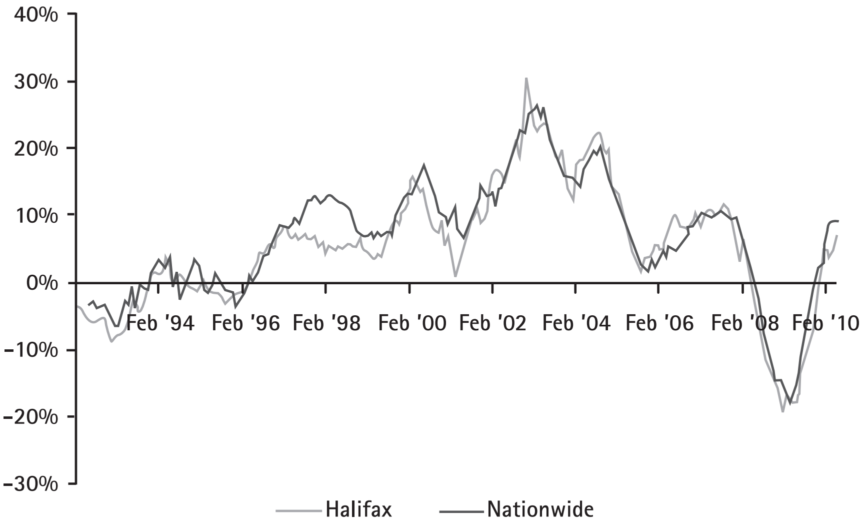
The impact of the changes in the mortgage market has been and will continue to be greatest on those with lower or less secure incomes, those with impaired credit histories, and those with limited access to deposits. It has been suggested that around 80% of successful first-time buyers are now reliant on family and friends for funds to finance a deposit.

A partial answer from government was the expansion of shared-equity schemes, allowing borrowers to access smaller loans, frequently with no deposit required – or at least with a very limited one. HomeBuy Direct facilitated the successful sale of a high proportion of private-sector new-build properties up to April 2010, and contributed significantly to the survival of the residential development industry during the recession. HA developers also benefited, though to a rather limited extent. However, the future scale of government-sponsored shared equity provision is uncertain.

Falling prices

The third assumption underpinning cross-subsidy, which rested in part on the previous two, was that house prices would continue to rise. This would, in turn, provide the opportunity to squeeze surpluses from new-build development that could cross-subsidise general-needs housing. Again, for the period to 2007 the evidence appeared to bear this assumption out, at least for those whose memories did not extend to the last recession (see figure 3).

Figure 3: Annual house price growth



Source: Council of Mortgage Lenders, 2010

Since 2007, the effects of mortgage funding constraints, economic downturn and negative perceptions by prospective buyers have combined to cause a severe downturn in prices and an uncertain outlook for the future. While there has been a partial recovery since mid 2009, prices remain around 9.5% below their October 2007 peak, according to Nationwide. There are signs that this recovery may in part have been fuelled by a desire to take advantage of the temporary stamp duty concession offered by the chancellor, which ceased in December 2009.

Since then house price indicators have shown an uncertain picture, with the Halifax index showing falls in four of the first six months of 2010. In January 2010 the *Financial Times* reported that 50 out of 78 economists questioned considered that residential property in the UK was still overvalued.[10] Transaction levels remain at historic lows, and there are fears that as more property appears on the market prices could edge downward again. Attacks on the social wage, via government cuts and curtailment of mortgage rescue and other state-sponsored forbearance measures, would exacerbate any renewed downward trend.

The cross-subsidy model under pressure

Developing HAs have been directly affected by the downturn in the housing and mortgage markets. The recent TSA survey of HAs[11] reported that in April 2010, some 5,196 low-cost home-ownership (mainly shared-ownership) homes remained unsold. While this figure represents a very significant improvement over the 10,000 unsold properties outstanding in January 2009, more than two-thirds have been on the market for more than three months, and almost half for more than six months.

The improvement has partly been achieved through more effective marketing, conversion to intermediate renting and realism about sales prices, but has also been effected by the reduction in new development, as "… providers have continued to monitor their development plans in response to the prevailing market conditions".[12] The same survey draws attention to rising impairment charges on land banks and to a reduced pipeline of 11,491 units in the process of development over the next 18 months.

The TSA survey confirms that HAs continue to be seen as a relatively safe investment haven by both lenders and capital markets investors, with 99% of facilities required over the next 12 months now in place. Nevertheless, the £3.5 billion of facilities arranged in 2009/10 is less than half of those arranged in 2008/09 (£7.4 billion), and anecdotal evidence

10 *Financial Times*, 4 January 2010
11 TSA *Quarterly Survey of Housing Associations April 2010* (June 2010) (www.tenantservicesauthority.org)
12 Ibid

from lenders confirms that this represents a lack of appetite from HAs rather than an unwillingness to lend.

The TSA's *2009 Global Accounts of Housing Associations*[13] confirms that the financial capacity of the sector to gear up for development is "by no means exhausted". In January 2010 it reported that "unutilised security has remained stable at circa £24 billion".[14] The cost of private funding has come down from the elevated levels of 2008/09, and interest rates on new lending are generally conceded by the sector to be at realistic levels. The funding picture is, overall, one of adequate financial capacity and reasonable access to funds; the downside is a reduced demand for funds by HAs, owing in large part to reduced development programmes.

This is not to deny that there has been some decline in the willingness of banks to offer the long loan maturities (25-30 years) traditionally preferred by the sector. On the other hand, access to the bond markets has improved, via both direct bond issuance and aggregating funders. The causes of the current problems do not lie in issues associated with access to private finance, and neither does their solution.

Even without reference to recent coalition spending decisions, the reasons for the growing lack of enthusiasm for future development are not hard to find. *Social Housing* magazine has estimated that the total surplus from HA property sales almost halved to £270 million between 2007/08 and 2008/09.[15] According to the *2009 Global Accounts of Housing Associations*, this surplus on sales eroded from £336 million in 2008 to £241 million in 2009, with overall HA surpluses down by £116 million. While it is possible that some of this "lost" surplus may be reclaimed through shared owners belatedly staircasing towards full ownership in future years, their propensity to staircase will be heavily dependent on the outlook for the economy, the state of the housing market and the availability of mortgage finance.

Over the past two years the Homes & Communities Agency has disbursed large amounts of grant to enable HAs with unsold properties to convert to intermediate renting, frequently on a "rent-to-buy" basis. There is no confidence in the sector that such financial assistance will be available in the future, and development plans are being curtailed in consequence.[16] Recent financial cuts announced by the coalition

13 TSA *Global Accounts for Housing Associations 2009* (March 2010)
14 TSA *Quarterly Survey of Housing Associations & Review of 2009-10* (January 2010)
15 "Sector's Asset Sales Surplus Halved as Shared Ownership Margins Tighten" in *Social Housing*, June 2010
16 "Sector's Financial Troubles and HCA Bail-out Point to Fundamental Governance Vacuum" in *Social Housing*, October 2009

(see following chapter) will only exacerbate declining confidence and lack of appetite for development.

As table 1 demonstrates, housing starts by HAs have dropped over the period. Though the decline was less severe than for the private sector, the recovery has been still more limited. The indications of a diminished development pipeline cited above combine with this data to suggest that even under present conditions, the level of development activity by HAs is declining and will decline further. Uncertainty about future government intentions in respect of grant and lack of confidence in the cross-subsidy model under present conditions are frequently expressed reasons.

According to the TSA: "Shared ownership development has decreased dramatically by over 50% nationally, meaning that cross-subsidising general needs from shared ownership proceeds is effectively no longer anticipated."[17] This is not true for all associations in all areas. In parts of London for instance, some HAs are still successfully marketing low-cost home-ownership properties on a viable basis. Nevertheless the TSA assessment is reasonable as a generalisation.

Examination of the figures for housing starts in table 1 reveals one other interesting, if minor, development. The Q1 2010 figure for local authority development, at 200, is a record for recent years, though still insignificant in comparative terms. It is perhaps indirectly indicative of a shift in government attitudes towards local authority housing development during the 2007-10 period. Having focused almost exclusively on HAs as the medium for affordable housing development for more than two decades, the Labour government signalled a change of heart towards local authorities in the shape of the proposed housing revenue account settlement, which would free up authorities to prudentially borrow against their assets. In the event, the settlement was overtaken by the general election and will be considered by the new government. Nevertheless, it was a pointer towards a possible new development option that will be discussed later in the paper.

17 *2009 Global Accounts*

Table 1: Housing starts by tenure, 2007-10

Date	Private sector	Registered social landlords	Local authorities	Total
2007 Q1	43,040	6,280	50	49,370
Q2	39,510	6,030	70	45,610
Q3	39,170	5,760	30	44,960
Q4	32,880	5,250	10	38,140
2008 Q1	27,450	6,780	80	34,300
Q2	23,810	7,260	120	31,180
Q3	14,040	5,150	10	19,210
Q4	10,650	3,790	160	14,600
2009 Q1	11,320	4,020	20	15,370
Q2	14,690	4,390	50	19,120
Q3	18,920	4,900	30	23,850
Q4	15,730	4,030	60	15,730
2010 Q1	19,480	4,890	200	24,570

Source: Department for Communities & Local Government (www.communities.gov.uk)

Chapter 3

The coalition – current prospects for affordable housing

The coalition – current prospects for affordable housing

"The age of aspiration is back!" On 8 June 2010, in a speech to the Royal Institution of Chartered Surveyors, housing minister Grant Shapps set out an optimistic vision in which he committed himself to "work[ing] every day to help people achieve their aspirations to own their own home". Shapps stated his intention to help 1.4 million households that cannot currently gain access to home ownership. Market renting and social housing could also be part of a range of valid choices that would make "aspiration" a touchstone of government policy. The rhetoric was positive and upbeat.

The difficulty is that the real prospects for affordable housing development are the worst for many years. The government has yet to convincingly demonstrate that a combination of localism and access to private finance will address the fundamental problems facing affordable housing providers. In addition, it has announced plans that could make things worse. There is a real risk that the rhetoric of aspiration could simply set the scene for bitter disappointment.

Cuts and more cuts

The £6.2 billion of Budget cuts for 2010/11 announced on 24 May 2010 by new chancellor George Osborne signalled a decisive and rapid move from a neo-Keynesian response to post-banking crisis economic conditions to a more orthodox approach of swiftly cutting public expenditure to reduce both accumulated national debt and the on-going deficit. Though the UK debt was not out of line with those of the rest of the EU 15 and is of relatively long maturity compared with that of Greece, the previous government had already flagged the need for a reversal of the stimulus approach aimed at mitigating the risk of economic downturn. The new government has brought this reversal forward in time, and other EU states, notably Germany, are taking a similar line.

The *Financial Times* noted that these initial cuts represented some 3.2% of the communities department budget (£1.18 billion).[18] On the face of it, the department appeared not to be singled out, with a number of others – notably those for work and pensions and for transport – apparently faring worse. This ignored cuts already imposed by the Labour government, however. It also ignored an alleged failure by the last government to fund £780 million of committed development schemes, whose future is now in doubt.[19]

18 "Age of Austerity" in *Financial Times*, 25 May 2010
19 "Shapps: The Coffers are Empty" in *Inside Housing*, 11 June 2010

Not only will local government suffer combined cuts of some £1.66 billion for 2010/11, but ringfencing of certain areas is being cut back. Within the communities department, cuts include £146 million off the housing and planning delivery grant and £30 million from Supporting People. The National Affordable Housing Programme is to lose £100 million of unallocated spending and Kickstart is to lose £50 million. HM Treasury did announce a £170 million once-off allocation to safeguard 4,000 social rented homes to be started during 2010/11;[20] nevertheless, the direction is clear and the Homes & Communities Agency is already making difficult choices.

On 22 June the chancellor announced his emergency Budget.[21] Overall, although he ruled out further cuts in capital investment in 2010/2011, he outlined a Budget that would reduce spending across departments by around 25% by 2014/15. Clearly, the detailed disposition of cuts will await the autumn comprehensive spending review. In addition, the chancellor announced caps and a recalculation of the local housing allowance that must have some effect on rent levels in the private rented sector. So far, action on housing benefit for the social rented sector includes limiting the benefit payable to those of working age occupying larger properties than their household size warrants and cutting by 10% the benefit of those claiming jobseeker's allowance for more than 12 months. The latter will have a significant impact on HA revenues.

The chancellor also announced a rise in VAT, which will significantly affect HA costs. It has been estimated that additional VAT payments by HAs could total £125 million a year, amounting to up to half the entire annual surplus of HAs.[22]

These early signs of government thinking confirm two clear conclusions:

- The cuts are to be on-going year-on-year until at least 2015, and represent a substantial on-going reduction in spending (around 25% compared with 2010/11) from then onwards.

- After an initial concession in 2010/11, housing is in no sense a priority to be ringfenced or otherwise protected.

The implications for affordable housing are clear; the amount of grant to be allocated is to be severely curtailed, whether by axing the number of schemes to be supported

20 HM Treasury press notice, 24 May 2010 (www.hm-treasury.gov.uk)
21 HM Treasury *Budget 2010* (June 2010)
22 Estimate offered by David Montague, chief executive of London & Quadrant, at Smith Institute seminar on affordable housing in London, 5 July 2010

or (as has been announced in Scotland) by lowering the rate of grant per home. It appears that provision for shared equity as well as shared ownership is under threat. This simultaneously puts pressure on HA developers to squeeze more from the cross-subsidy model. It also makes the gap to be bridged by open-market sales surplus larger, and hence puts developing HAs under more intense financial stress.

Without an alternative strategy, such a situation can only lead to an accelerated downturn in affordable housing development of both properties for sale and grant-subsidised housing. It also implies increased risks for those HAs that stay in the game. As the TSA put it: "Cuts in grant could either force the sector to reduce its expansion rate or find alternative sources of funding, which will increase leverage and reduce interest cover – in turn increasing lending risk and therefore lending cost."[23]

Housing benefit reform

The appointment of Iain Duncan Smith as secretary of state for work and pensions was a clear indication that reform of housing benefit is on the agenda. Duncan Smith has worked with the Centre for Social Justice on benefit reform and is closely identified with its paper *Dynamic Benefits: Towards Welfare that Works*.[24] Appointment of the centre's director as the minister's special adviser can only strengthen the supposition that reform is on its way.

While much of the Centre for Social Justice thinking concerns the transition from benefits to work, there is also a strong simplification agenda, with the proposition that the complex network of benefits could be reduced to two: a universal work credit and a universal life credit. In addition, given the background of public expenditure cuts, the £17.4 billion housing benefit budget is inevitably the subject of scrutiny, particularly as it was expected to rise to £20 billion over the coming year, prior to the latest Budget announcement.

The Budget confirms the existence of a reform agenda, though the brunt of cuts has so far applied to the private rather than the social rented sector. Nevertheless, the decision to reduce the benefit of the long-term unemployed suggests a willingness to consider strong measures with unwelcome effects.

A reform programme that had the effect of capping housing benefit, and thus removing its inflation-proof status, and of detaching benefit from the actual rent

23 TSA *The Impact of the Credit Crunch on Housing Associations* (2010)
24 Centre for Social Justice *Dynamic Benefits: Towards Welfare that Works* (2009) (www.centreforsocialjustice.org.uk)

paid would strike at a key element of comfort for HAs and those who invest in them. If simplification (as seems very possible) led to a move away from payment of housing benefit direct to landlords, there would be immediate fears over rent arrears and collection costs.

As already indicated, housing benefit as it exists is an essential and pre-eminent element in underpinning lender and investor involvement in the sector. A serious threat would immediately serve to increase lending rates and to reduce the willingness to support present leverage levels of developing HAs.

The TSA has expressed serious fears: "While social rents are limited by the restructuring regime they are also in part covered by the state through housing benefit. This provides RSL businesses with a solid, low-risk foundation for their activities. Reductions in housing benefit could undermine this as the balance would presumably have to be paid by tenants, increasing the risk of bad debt."[25] It is not always recognised that the threat of reduction to or tampering with housing benefit is perceived as so serious by funders that major change appears as a default or rescheduling event in some loan covenants, in some circumstances giving lenders the opportunity to take immediate action to review loan conditions or even to revoke a loan altogether.

The TSA and regulation

As has already been indicated, the existence of an effective regulatory regime has been another key element in enabling HAs to lever in private finance at rates well below those prevailing for private-sector developers. Government has, usually, understood the importance of regulation and has acted decisively to ensure not only the existence of regulation focused on financial viability and sound governance, but that such regulation be supported by a regulator with strong enforcement powers and sufficient resources to make those powers a practical reality.

In 2006 it was discovered that the Housing Corporation had not correctly used its powers to give consent to HAs to offer lenders loan security over their land. This created uncertainty as to whether some £35 billion of secured lending was in fact unsecured. Following talks with lenders, the government moved rapidly to deal with this regulatory problem through an emergency bill in parliament, which became law in just over six months.[26] Similarly in the period preceding the enactment of the Housing Act 2008, which established the TSA and the new regulatory regime, the

25 TSA *The Impact of the Credit Crunch on Housing Associations* (2010)
26 The Housing Corporation (Delegation) etc Act 2006 (www.opsi.gov.uk)

government consulted closely with lenders and HAs to ensure that the provisions of the act would properly support investment to the sector.

While still in opposition, the Conservatives announced their view that the TSA should be abolished. In spite of defensive action in the form of pre-emptive budget cuts by the TSA, the new government has now announced that the TSA will be abolished.[27] Its regulatory powers will go to the Homes & Communities Agency, with the Housing Ombudsman handling tenant complaints.

The institutional arrangements for regulation have always been less important to lenders than the powers, focus and funding of the regime itself. Lenders and capital market investors accepted the abolition of the Housing Corporation in 2008 because there was confidence that a viable regime would be delivered regardless of the identity of the regulator. The problem in 2010 is that there has not so far been substantial acknowledgement from the new government of the key importance of regulation, and in the meantime the existing regulator is announcing cutbacks. Shapps' comment that "I think [the TSA] was set up as a very expensive way to do some reasonably straightforward things" does not inspire confidence. Nevertheless, institutional investors (if not banks – the majority funders) may be pleased to hear that "I'm keen to ensure that institutional investors feel safe with their money".[28]

At a time when the financial markets are nervous in the wake of the Greek crisis and concerned about the broader implications of government cuts, such a situation of uncertainty is potentially damaging in itself. Neither lenders nor investors have to place funds with the HA movement. A prolonged period of uncertainty or, worse, a decision to abolish the existing regulator with inadequate assurances about the robustness of the regime going forward could lead to an undermining of the commitment of those who fund the sector.

In its draft corporate plan, the TSA has already announced that it will cut its operating budget by 10% a year while taking on the regulation of local authorities for the first time. Such news is not calculated to reassure nervous lender credit committees.[29] Ironically, the TSA also claims that it saves the taxpayer £500 million a year in cheaper borrowing by HAs and that it intends to lever in a further £15 billion of private finance by 2013. Failure to take regulation seriously could cost HAs and government dear.

27 "Shapps to Scrap TSA" in *Inside Housing*, 18 June 2008
28 Ibid
29 TSA *Draft Corporate Plan 2010-2015* (2010)

The ratings agencies appear to already be identifying the potential risks. Moody's was reported as stating publicly that "any significant weakening of the regulatory framework could have negative rating implications".[30]

Indirect effects of cuts

There is a broad consensus among both politicians and economists on the need for significant financial cuts across government budgets. Arguments about timing and about the existence of a political mandate for cuts have essentially been settled by the general election. Clearly, as has been seen, cuts in housing budgets will have a direct impact on funds available as grant and could impact on the housing benefit payments that support corresponding private investment. What cannot be ignored are the indirect effects of cuts in the social wage on HAs and their tenants. These will have significant effects on the financial performance, viability and development appetite of the affordable housing sector.

Such effects are hard to quantify, but some can at least be listed:

- the impact of increased unemployment and cuts to the social wage on HA rent arrears levels and on costs of rent collection and associated advice and counselling services;
- the downward pressure on average intermediate and market rental levels if tenants' financial circumstances deteriorate and if rents in the private rented sector fall;
- the possibility that antisocial behaviour and crime will increase, taking more HA resources to combat them and deal with the consequences in terms of damage and excessive wear and tear; and
- further downward pressure on open-market property prices as personal incomes and employment are affected, and if schemes to alleviate the impact of mortgage default are cut back.

While such effects are probably inevitable, they cannot be ignored in any assessment of development prospects and will be a drag on outcomes to be expected from any development strategy, innovative or otherwise. The leaked report from the Office for Budget Responsibility suggesting that 600,000 public-sector jobs will be lost as a result of the cuts as announced is just one reminder of this fact.

30 "Scrapping TSA Would Damage Associations' Credit Ratings" in *Inside Housing*, 11 June 2010

Further loss of appetite

As has been seen, the objective conditions for affordable housing development in terms of housing and mortgage market prospects were poor even before recent government financial decisions were announced. Confidence and appetite among HAs to undertake future development were low and falling. This was at least in part a consequence of a perception that, whichever party won the general election, heavy cuts in public spending were on the way, increasing the risks of development by:

- having a direct impact on future grant availability;
- putting the core rental income stream at risk through housing benefit cuts;
- causing further deterioration in the housing market due to job losses, with further knock-on effects on prospects for mortgages; and
- exacerbating the likelihood of a further economic slowdown, at least over the medium term.

The recent spending announcements by the coalition have offered substance to the above perception and added further concerns over regulation and therefore private finance availability. The rise in VAT is also believed to be likely to hit associations hard.[31]

Loss of appetite for development is a subjective phenomenon but it is real nonetheless. It is also likely to remain a factor even if some negative effects of recent changes can be mitigated, as HAs decide to avoid risking their financial integrity and resolve to focus on their core business of providing landlord services to existing tenants.

Thus the perception by many HAs that the risks of substantial development are too high will be a real and unavoidable factor in the development equation going forward; for many it is a case of "once bitten, twice shy".

A gloomy prospect

An assessment of future development prospects must combine recent economic and market changes affecting the affordable housing sector with the likely impact of the reaction of the coalition government to the economic and financial pressures it faces. On the basis that current development strategies and models are pursued in a broadly similar way into the medium term, the prospects for affordable housing development are somewhat grim.

31 "VAT Rise to Hit Associations Hard" in *Inside Housing*, 25 June 2010

- Development via the cross-subsidy model has already faltered and many consider that model broken. Development of other tenures such as intermediate renting has been sustained only by exceptional injections of grant. Housing market conditions remain precarious. There would be a prospect of progressive reduction in affordable housing development even without financial measures by the new government.

- Cuts to central government housing budgets, in particular grants, will further reduce the number of HAs engaged in development and increase the risks to those that remain in the game. Output of both open-market sale and general-needs properties will further reduce.

- Reform of housing benefit and changes to regulation could reduce the flow and increase the costs of private finance, as well as reduce the financial capacity and development appetite of HAs.

- Overall reductions in government expenditure will have a knock-on effect on HA revenue and costs.

- HA development appetite, already reducing, has been dealt a further severe blow and will be difficult to rebuild.

It appears likely that whatever strategy for development is in place, some further reduction in the volume of affordable housing development is inevitable. Nevertheless, the prospects for development without an innovative approach to future strategy are so gloomy as to make the search for such a new approach urgent and necessary from the perspective of government, the delivery agencies, HAs themselves and their funders. The remainder of this paper aims to contribute to a broader discussion of what form a new strategy might sensibly take.

Chapter 4

Bridging the gap – possible components of an alternative strategy for affordable housing

Bridging the gap – possible components of an alternative strategy for affordable housing

Preceding chapters have argued that without action to alleviate the situation, affordable housing provision is likely to reduce progressively over the medium term. In looking to identify the elements that might comprise an alternative strategy for funding affordable housing, a number of possible avenues can be explored. The thinking behind these proposals has been developed from within the sector and they have all been aired publicly in recent weeks. What follows is an attempt at synthesis rather than an aspiration to originality. Collectively, the proposals represent an approach to limit the damage caused by a deteriorating situation rather than a means to restore development to previous levels. They are not a panacea and most have unfortunate social consequences.

Tenure: time for a change in direction?

The cross-subsidy model has essentially prioritised the development of properties for open-market sale (largely via shared ownership and increasingly in the form of flats) and maintained the development of general-needs housing through subsidy from open-market sale and social housing grant. Since cross-subsidy is increasingly untenable and grant is likely to diminish sharply, an obvious question is whether other tenures can be built on a basis where no or little subsidy is required.

One byproduct of the housing market downturn has been the recourse of HAs to intermediate and market renting to deal with unsold newly developed properties. What started as an expedient supported by HCA grant could form a pointer to one possible way forward.

Market renting

The private rented sector has formed an increasingly important component of government's overall housing strategy for some years. The government response to the Barker review in 2005[32] recognised private renting as a key flexible tenure able to cater for a growing number of households for whom home ownership and social renting may not be options. These include:

- increasing numbers of students;
- those on housing benefit;
- younger households, which aim to access home ownership but cannot yet

32 HM Treasury and ODPM *The Government's Response to Kate Barker's Review of Housing Supply* (December 2005)

afford to do so;
- those in transition owing to family break-up; and
- recent migrants.

Private rental is still too often seen by HAs as an inferior tenure served by seedy post-Rachman landlords and exhibiting poor conditions. Such an assessment is outdated: as the 2008 Rugg review of the sector pointed out, stock condition has improved dramatically, not least thanks to recent buy-to-let investment; while the ownership structure of the sector, centred on smaller individual landlords, has delivered an efficient, good-quality service for tenants with which institutional landlords have found it hard to compete profitably, outside certain niche markets.

According to the English Housing Survey, private tenants are actually more satisfied with their accommodation than social renters (83% against 78%),[33] while overcrowding is greater in the social rented sector than in the private rented sector – statistics that provide food for thought.

In February 2010 HM Treasury published a consultation paper, *Investment in the Private Rented Sector*.[34] The report is of interest in the way it demonstrates the centrality of the sector in official thinking about future provision and supply of housing. The report claims that the private rented sector has played a "disproportionate" part in boosting housing supply, having accounted for around a fifth of new-build purchase in 2007/08. It reiterates the message that the sector is well run in the main but draws attention to the problem caused by the massive cutback in buy-to-let investment, which it calculates now funds some 35% of all private rented stock.

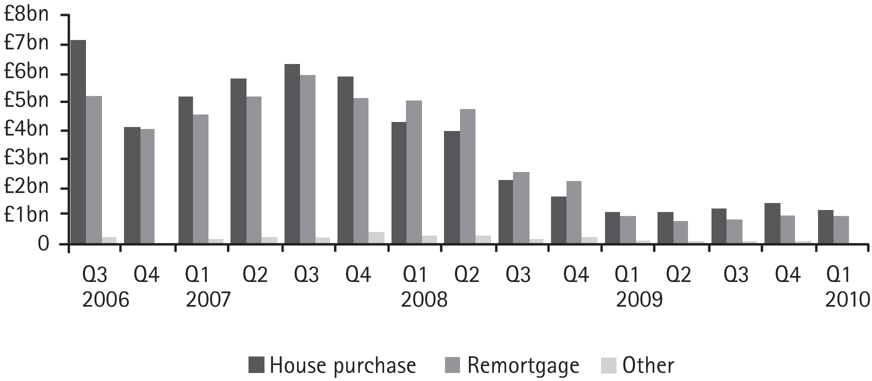
The consultation paper seeks new ways to bring in institutional investment but recognises that rental returns are insufficient at present to attract the commercial sector. In so doing, however, it implicitly highlights a possible expanded role for HAs. As experienced corporate landlords from the not-for-profit sector, HAs are used to operating on tight margins, and have in many cases have had (inadvertent) experience of developing new-build market-rented properties.

Clearly, there are problems regarding HAs' high costs compared with those of private landlords, as Derek Joseph has pointed out.[35] Nevertheless, if costs can be reduced in

33 DCLG *English Housing Survey: Headline Report 2008-09* (February 2010)
34 HM Treasury *Investment in the Private Rented Sector* (February 2010)
35 Joseph, D "RSL Staffing Costs 08/09: Inefficiencies Hamper Funding of New Social Housing" in *Social Housing*, March 2010

a largely unregulated environment (minsters have indicated that they do not intend to proceed with the previous government's plans to introduce registration and further regulation in the private rented sector), then HAs in some parts of the country at least may be able to develop on a no-grant, or at least a low-grant, basis.

Figure 4: Buy-to-let gross lending



Source: Council of Mortgage Lenders

Such an option is not a panacea; in some parts of the country private-sector rents are extremely low, and in some city centres there is already a surfeit of new-build flats for rent, many built by HAs themselves. There are also negative social consequences of moving towards market-rented rather than general-needs housing that should not simply be ignored:

- Higher rents would make the transition from benefits to work more difficult to manage without creating negative incentives, thus increasing the risks of fostering long-term worklessness – though reform of housing benefit might mitigate this effect to some extent (see below).

- Those at work but on low incomes would be hit financially.

- Aspirations towards home ownership would remain unrealisable for many, with a decline in shared-ownership provision.

- There would be problems regarding managing situations in which tenants with similar incomes pay different rents to the same landlord, where one tenant is in general-needs housing and one is paying a market rent for a similar property.

- The present emphasis on varied housing offers to create mixed communities would become less viable. Those on benefits or with low pay would be increasingly poorly represented, while shared-ownership and shared-equity provision would atrophy. The financial constraints of development for rent without grant could lead to pressure to build large, purpose-built, mono-tenure apartment blocks.

While there are difficulties to be overcome and inevitable shortcomings to such an expedient, shifting the balance in favour of private renting might at least help to maintain the supply of homes at (relatively) affordable rents and to boost overall housing supply. It should be noted, however, that further development of market renting may not be desirable in all local housing market areas. In some, the increase in supply could depress private rents and even force some private landlords out of business. The relationship between market and social rents needs analysing to avoid creating unforeseen outcomes.

A future for intermediate renting?

Intermediate renting has tended to function as an expedient to deal with unsold properties developed for the market, and has included properties offered on a "rent-to-buy" basis with built-in purchase opportunities and an expectation (hope?) that such properties are only to be a short-term addition to the local rented stock.

In spite of having funded large numbers of rent-to-buy properties in London and elsewhere, notably via the Kickstart programme, it appears that hitherto the Homes & Communities Agency has had reservations about a long-term role for intermediate renting. Spokespersons have pointed to the policy issues surrounding use of scarce grant to provide subsidised housing for those not in the greatest need: a powerful argument as it stands. It appears that building for intermediate renting without subsidy is usually only possible if the rental offer is for a limited time only, with the property offered for sale after an agreed period. This creates risk for both HAs and their tenants.

If a market renting option were also to be pursued, there would be the potential for a three-tier rental segmentation within the affordable housing sector: properties let on market rents, presumably on assured shorthold tenancies; properties let at intermediate rents of around 80% of market rents, again on assured shorthold tenancies; and general-needs housing, fully subsidised and with security of tenure.

A distinction between general-needs and market-rented housing appears easier to justify in terms of special provision for those identified as being in need, though clearly there is the possibility that such arrangements would be perceived as inequitable by tenants. A third tier would add a complexity difficult to justify unless supported by detailed analysis of particular local rental markets. It has been suggested that the allocation between market, intermediate and general-needs rent would imply a means test, which would add further cost and complexity and would only be "fair" at the moment of application.

An alternative approach would be to offer higher rents for better properties and/or levels of service, justified in terms of consumer choice. Given regulatory requirements for general-needs housing, this would be difficult in respect of levels of service. For many HAs, such an approach would imply a further residualisation of general-needs housing and would be unacceptable on that score.

An additional concern with the intermediate option is that the subsidy required is still substantial in many cases, unless there is an assumption that tenants will purchase the property within a certain timescale. By some calculations, and for some developments, it is close to that required for general-needs housing. This raises the issue of grant availability, and from an HA perspective could be considered a less attractive option in that rental receipts will be lower and regulatory constraints (for example, on disposal) greater than for market renting.

Clearly, these issues feed into the wider on-going debate about security of tenure and rent levels in general-needs housing. Nevertheless, even without settling those debates, it would appear that an intermediate tier of renting offers HAs a lower rental income stream than market renting, requires more grant to build and offers on-going complexity in terms of allocation. For many HAs it would be hard to justify as part of a planned strategy. There may be a continuing role for limited-term rent-to-buy as a specific product, but this suffers many of the disadvantages of shared ownership from an HA perspective and is unlikely to flourish without continuing grant support.

It is clear that for some HAs in some areas, intermediate renting does offer genuine possibilities. London & Quadrant has had success with its *Up to You* product, offering homes at 80% of market rents with the opportunity but not the obligation to buy, and is now investigating the possibility of a new tier offered at 65% of market rent.[36]

Even these would appear to have a proportion of sales as a necessary component. As the housing market drifts towards another period of uncertainty, such a necessary component would be seen as problematic by many HAs. Overall, however, it appears that a general move towards intermediate renting as a permanent tenure is unlikely and would be widely considered to be undesirable.

Housing benefit: reconciling priorities

As already indicated, housing benefit as an HA income stream is a fundamental element in the continued access to private finance on the present advantageous terms. In particular, the key characteristics of social-sector housing benefit that make it an attractive and safe income stream from a funder's perspective are that it:

- is effectively inflation-proof and thus attractive to pension funds and other capital market investors as well as banks;
- covers the whole rent paid if the tenant is eligible, though the recently announced reduction in benefit for the long-term unemployed partially undermines this principle; and
- is paid direct to the landlord rather than the tenant.

Previous government attempts at reform have focused on the latter point, seeing direct payment to tenants as a way of promoting personal responsibility. HAs and funders have always strongly resisted any moves toward direct payment, claiming that it would lead to escalating arrears and greatly increased collection costs. The case against direct payment was decisively strengthened by a pilot scheme carried out among around 1,000 tenants by London & Quadrant. With months of the switch to direct payments to tenants, arrears and collection costs had escalated to such alarming levels (in spite of significant support offered by L&Q) that the pilot had to be rapidly put into reverse.[37]

Previous government reform initiatives have foundered on the opposition of funders and HAs themselves. Simple opposition appears much less likely to be successful in relation to proposals that may be put forward by the coalition. The minister is clearly committed to reform, and has studied the terrain while in opposition. The case against reform of some aspects of housing benefit has become increasingly difficult to make; problems with making the transition from benefit to work are a case in point.

36 Speech by David Montague (London & Quadrant chief executive) to Smith Institute seminar on affordable housing in London, 5 July 2010
37 London & Quadrant *Where's the Benefit?* (2004)

In addition, the sheer scale of housing benefit expenditure means that under present public expenditure constraints it would be difficult for the coalition to fail to examine an area where they already have doubts about whether money is being spent to the best advantage.

The aim for those concerned to secure the income stream on which future private funding of affordable housing will be based must therefore be to look at whether there is an "acceptable" approach to housing benefit reform that will secure some or all of the government's likely objectives but would leave the key essential characteristics cited above intact.

It would appear that government is likely to have four objectives in seeking to reform housing benefit:

- to simplify the benefit system and make it easier for claimants and others to understand and negotiate;
- to ease the transition from benefits to work;
- to increase the sense of personal responsibility of tenants in terms of meeting their financial obligations, including their responsibility for the rent in the home where they live; and
- to examine whether the costs of a demand-led and inflation-proof benefit can be further controlled or reduced (the recent Budget of June 2010 has made an initial move on this).

These are the issues on which attempts to identify an acceptable approach to reform will have to focus.

Simplification should not in principle be problematic. The key issue from a funder perspective is that the benefit should relate to, and cover, the individual rent paid by the tenant. However, this does not preclude it being an identifiable element within a broader-based benefit covering subsistence costs, rent and other costs, which could be accessed as part of a single application process. In effect supplementary benefit, introduced in 1966, had these features until it was reformed in the 1980s.

The issue of transition to work has been examined in some detail by the Centre for Social Justice[38] and the objective is difficult to oppose. However, as reformers have pointed out, easing the benefit-to-work transition is likely to increase the costs of

38 Centre for Social Justice *Dynamic Benefits: Towards Welfare that Works* (2009)

benefit rather than reduce them and would be likely to increase rent arrears. In their joint response to the welfare reform white paper, a number of organisations (including the National Housing Federation and the Chartered Institute of Housing) put forward a range of proposals to address this issue.[39] There is clearly the potential to develop a position that would be the basis of constructive dialogue between government and the affordable housing sector over this aspect of reform.

The responsibility agenda has usually led proponents of reform in the direction of direct payment of benefit to tenants. As has already been stated, the evidence of a substantial pilot in this area is very negative. Debt lenders, rating agencies and capital markets investors have already drawn their own conclusions on direct payment; for many it is a defining issue. The immediate effect of such a move could be for some lenders to activate clauses that make major changes to housing benefit a rescheduling event under existing covenants, thus allowing upward repricing of existing borrowing. Over the longer term, rates would rise while asset and interest cover requirements would become more onerous. Some lenders and investors could desert the sector over this issue alone.

Clearly, government has the power to ignore such risks, but the consequences of so doing could be very expensive in terms of the need to support a sector whose terms of financing had markedly deteriorated. In any case, it should not be forgotten that social tenants already have the choice to have their rent paid directly to them should they opt for that option, which most do not.

It would seem that the answer here is to seek alternative ways of promoting tenant responsibility. Such an approach might focus on:

- ensuring that tenants receive regular clear accounts of the actual rent attached to their property and a periodic account of how much benefit has been paid on their behalf to meet it; and
- striving to ensure that tenants know how rents contribute to the various services provided by their landlord and encouraging them to participate in tenant involvement initiatives that enable participation in setting service priorities.

Funders to the sector would probably react to moves to cap housing benefit in a similar manner to their reaction to moves on direct payment. The existence of an inflation-linked benefit covering the whole rent payable is seen as a key comfort. This is, from a sector viewpoint, the most difficult area of all, and it may be that government will need to

39 Chartered Institute of Housing, Citizens Advice, Child Poverty Action Group, Crisis, National Housing Federation and Shelter *Joint Response to Welfare Reform White Paper* "Raising Expectations" (February 2009)

accept that the costs of breaking the link between housing benefit rent levels and inflation are too high in terms of lost development and additional financial demands on government itself.

HAs themselves have made it very clear that cutbacks in housing benefit or moves towards direct payment would have a direct impact on development plans and could threaten viability, thus confirming the TSA analysis cited earlier in this paper.[40] So far only a modest cutback in social rented housing benefit has been made, compared with those applied to private-sector benefit. This suggests at least some recognition by government that this is a more sensitive area. Clearly, the case must be made that private and social rented housing benefit cuts are not the same in their implications and that housing benefit in the social rented sector must be considered for its role in underpinning new and existing investment.

In summary, therefore, there is scope for striking a balance that recognises the desirability of reform to housing benefit but which also safeguards the legitimate interests of private finance providers and the financial capacity of HAs.

Rent levels: an opportunity?

Some 65% of social rent receipts are paid by housing benefit and therefore the level of rents directly determines the benefit bill. At first sight the above statement would seem to imply that from a government perspective rent levels should be kept down, in the interests of limiting housing benefit payments. Paradoxically, the opposite could arguably be the case.

Three important considerations should be borne in mind:

- Increasing prevailing rented levels in the affordable housing sector enhances the overall financial capacity of the sector, since the valuations on which asset cover for loans are calculated have usually been cash-flow-based. In addition, enhanced rent levels have a positive impact on loan interest cover ratios.

- Additional revenue to social landlords and a cut in the percentage subsidy has a direct impact on the level of grant needed for future subsidised development.

- An increase in receipts is likely to be significantly greater than the increase in the benefit bill, since housing benefit covers only a proportion of any increase in rent.

40 "News Analysis" in *Inside Housing*, 4 June 2010

The above propositions should be subjected to proper financial modelling. Nevertheless, it appears likely that such modelling would bear out those propositions to varying degrees. If this is the case, then allowing rents to rise holds out the prospect of increasing the financial capacity of HAs to lever in private finance while simultaneously allowing government to reduce grant levels.

Peter Marsh of the TSA has recently lent his support to a variant of this option by suggesting that existing general-needs properties could have their rents increased to intermediate or market-rent levels on re-letting, claiming that if this approach were applied to 25% of the stock of vacant properties of larger landlords, the additional revenue could be the basis for building up to an additional 10,000 homes a year.[41]

Such a scenario is not without social costs:

- The transition from benefits to work would be made more difficult (or there would be some increase in benefit payments to ease the transition under a higher rent regime).

- Those not in receipt of benefits but on modest incomes would be financially hit. This raises particular issues in areas where housing costs are high in any case, such as many parts of London.

- The concept of mixed communities would be still more difficult to realise, as those previously reliant on general-needs housing on grounds of income would have less access to new and/or existing developments.

Nevertheless, raising rents would, in principle, allow for increased development with less government subsidy and offer some overall saving to the public purse. The amount of extra development and the savings to government would depend on how much rents were allowed to increase and also on the degree of rent subsidy implied in any new development. A move towards market-rented development would clearly maximise the number of units that could be built.

Raising rents is not a panacea, however. There are areas where private-sector rents are low and where the potential to increase social rents and maintain occupancy levels is limited or even non-existent. Again, such local effects would need proper

41 Marsh, P "Future Housing Development Hangs on RPs' Willingness to Consider Radical Changes" in *Social Housing*, July 2010

modelling, to obtain a real understanding of effects across the country and the overall potential and to identify areas where relatively more grant or other funding expedients might be appropriately deployed.

Regulatory reform

A key to maintaining the financial capacity of the sector and its ability to access private finance at advantageous rates is HA regulation. As already indicated, the government has signalled its intention to abolish the TSA. While regulatory disruption is viewed as undesirable by funders, a change in institutional arrangements is not seen as intrinsically problematic; the issue is the focus and effectiveness of the ensuing regime.

The important criteria for continued funding are:

- whether the regime focuses on governance and financial viability;
- whether the regulator (whoever it is) has sufficient powers to enforce compliance; and
- whether the regulator has access to adequate resources to make the supervision of HAs effective and to enable the regulator to use its regulatory powers in practice.

The affordable housing sector will need to make the case for continued regulation with focus on the above attributes. The case for a focus on governance and financial viability should not be difficult to make effectively. Neither should the granting of adequate powers. Indeed, there are strong precedents from both the Housing Corporation and TSA regulatory frameworks on which to draw.

More difficult will be the issue of resources. It is clear that government sees the TSA as expensive and that saving money is a central motivation for change.[42] In these circumstances the most powerful (and valid) argument from the affordable sector should be to point out that an effective regime actually saves government and the HA sector money.

The TSA has stated that it saves the sector some £250 million per year in reduced interest payments for funding. It calculates that for every £1 spent on regulation, £15 is saved in lower interest payments. It could also have stated that the existence of regulation allows higher leverage – that is, less grant.[43] The TSA may not be seen as an unprejudiced observer, but as already referred to, there is also independent research on the costs and benefits of regulation in relation to the Housing Corporation that draws similar conclusions.

42 "Shapps to Scrap TSA" in *Inside Housing*, 18 June 2008
43 TSA *Draft Corporate Plan 2010-2015* (2010)

While government should, of course, aim to streamline institutional arrangements in order to avoid waste and must examine the content of regulation to ensure that priorities are efficiently met, it is clear that eroding the effectiveness of regulation in the eyes of bankers and institutional investors would cost government dear in increased grant rates and in lost housing starts. Conversely, a strong case can be made for a collaborative approach to regulatory change that includes full consultation not only with tenants but with HAs, banks and investor representatives to ensure that one of the most successful public-private partnerships in the UK is not damaged.

Scope for efficiency savings?

The search for efficiency savings by all organisations, including those belonging to the affordable housing sector, is usually worthwhile, with always the possibility of some incremental improvement in costs. It is therefore reasonable to raise the prospect of efficiency savings in a discussion of how new development can be afforded going forward.

The National Housing Federation has suggested that the sector should continue to pursue efficiencies in a number of areas:[44]

- stock rationalisation, in order to cut down on the number of properties geographically separated from an HA's main stock in order to make saving on repairs and maintenance;
- extending the use of sale-and-leaseback where appropriate; and
- contracting out services, where this is less costly than undertaking services in-house.

The regulator has also long seen the promotion of efficiency as one of its goals and has committed itself to continuing this work going forward:

We will work with landlords to drive up value for money – by sharing information on costs and performance, by promoting stock and management rationalisation, by encouraging new entrants into the market and promoting new partnerships between existing providers.[45]

While the search for economies is laudable, it is not clear whether these can be achieved on a scale to contribute significantly to the HA development programme

44 National Housing Federation *Facing the Future: Evolution or Revolution?* (2009)
45 TSA *Draft Corporate Plan 2010-2015* (2010)

when measured against a major cutback in resources. The future shortfall in grant allocation alone could run into billons over a comprehensive spending review period. The impact of cuts in housing benefit or loss of confidence by lenders in regulation could be at least as great. In addition, there is no guarantee that organisations achieving the greatest savings would be those most likely to engage in development.

In any case, regulation has encouraged the search for savings on an on-going basis, thus lessening the likelihood that substantial new or unexpected economies will be discovered. Overall, while the search for efficiency savings will and should continue in any event, it is unlikely to make a major contribution to funding development going forward.

Local authorities: an enhanced contribution?

Local authorities have effectively been excluded from new development for over 20 years. Previous governments, for a mixture of political and financial reasons, chose to channel development through HAs rather than local authorities. In this calculation, a major influence on government was the desire to use existing affordable housing assets to lever in private finance, thus limiting the requirement for public expenditure and/or borrowing.

A major advantage for HAs over local authorities under this strategy was that HA borrowing stands outside the government public borrowing regime, and so does not figure on the public-sector balance sheet. In addition, local authority activity is constrained by the housing revenue account system, which involves a complex annual cross-subsidy of local authorities to achieve a formulaic distribution of revenues and costs. This means that local authorities are not free to keep or borrow against the revenues generated from their own stock.

The previous government began the process of questioning the exclusion of local authorities from participation in new development through proposing an ending to the housing revenue account cross-subsidy system and a final settlement under which local authorities would be net gainers or losers, and would henceforth be free to keep their own revenue receipts and to undertake some limited borrowing against their housing assets, valued at more than £25 billion and comprising some 1.8 million homes across 177 local authority areas.[46] Detailed proposals were published in March 2010, which also suggested that local authorities would have the capacity to build

46 DCLG *Reform of Council Housing Finance*[a] (2009)

some 10,000 homes a year without significantly increasing their borrowing beyond the levels defined by the settlement.[47]

In the event, Labour's plans were overtaken by the general election. Labour had agreed to forgo revenue in order to facilitate development by local authorities while still tightly limiting their borrowing ability. In the tighter financial environment now prevailing it is unlikely that such a generous settlement will be forthcoming.

Nevertheless, the new government is believed to be sympathetic to the overall approach to reform set out by its predecessor, and an announcement is expected in due course.[48] It is expected that around 75% of local authority housing receipts will be available for investment in affordable housing and regeneration. A major problem remains, however, in that overall borrowing will probably still be capped at around the opening post-settlement debt level for each authority, with additional borrowing dependent on the creation of "headroom" below that figure. Thus there is to be no untrammelled access to private debt finance.

The reason, of course, is not hard to find. Borrowing by local authorities for housing investment will continue to be counted as public-sector debt. While that remains the case, local authority affordable housing development, while welcome, is unlikely to make more than a small contribution to bridging the gap left by falling HA development numbers. This conclusion is reinforced by the fact that local authorities wishing to build general-needs or intermediate rented housing would require grant to make the financial equation work. Local authorities and HAs could therefore simply be competing for the same scarce resource. Whether local authorities can make a qualitatively larger contribution than that envisaged here would depend on the outcome, if any, of current debates on the classification of government spending.

Public debt classification

The debate on what should constitute public debt in the UK has been going on for at least 15 years.[49] The issue arises from the classification criteria operated by the Office for National Statistics[50] for what constitutes "general government" debt – and so falls within the scope of the public-sector borrowing requirement.

47 DCLG *Council Housing: A Real Future* (2010)
48 "Council Housing Finance Reform", Trowers & Hamlins slide presentation to Chartered Institute of Housing annual conference, 22 June 2010
49 Hawksworth, J and Wilcox, S *Challenging the Conventions: Public Borrowing Rules & Housing Investment* (Chartered Institute of Housing/Coopers & Lybrand, 1995)
50 Golland, J, Savage, D, Pike, T and Knight, S *Monthly Statistics on Public-sector Finances: A Methodological Guide* (Office for National Statistics, 1999)

At present, HAs and other private-sector bodies are classified as belonging to the "corporate trading sector". As such, their borrowing does not count as public borrowing. Local government borrowing however, is classified as coming within general government debt.

It has been persuasively suggested[51] that the UK should reclassify public debt using the narrower definition used in Europe and now adopted internationally by the IMF and OECD. This would effectively place investment in the trading activities of local authorities, as well as of private bodies, outside government borrowing limits. It is pointed out that the UK government has already excluded its investments in bank rescues from the public balance sheet, even though Northern Rock is publicly owned. As supporters of change also argue, a move to reclassify public debt would also safeguard the private-sector status of HAs, which has come under some threat because of EU requirements and court action.[52] Were HA borrowing to be reclassified as general government borrowing, future investment would be at risk, so a change to the classification criteria would be welcome on that score.

In relation to local authorities, it has been pointed out that redefining public expenditure would not in itself increase the scale of investment unless the likely caps on prudential borrowing were also raised. This statement is true as it stands. However, if local authority trading expenditure no longer counted as public borrowing, government could afford to be more relaxed about the scale of prudential borrowing than seems likely at present. There is, therefore, a genuine opportunity.

Given the obvious advantages of changing the classification of public debt, it may be seen as a straightforward move. Unfortunately, the UK government will also have to weigh up broader considerations. The financial markets have been in a state of heightened tension since the onset of the Greek financial crisis. The UK has so far escaped relegation to the PIGS status of Portugal, Ireland, Greece and Spain, and borrowing costs remain at reasonable levels in comparative terms. Nevertheless, the government strategy of reducing both the public deficit and the accumulated public debt has been largely driven by the perceived need to "prevent a bond market crisis".[53]

Government will wish to debate whether a move to international classification criteria in the field of public debt will be perceived by investors as bringing the UK

51 For example: Perry, J and Wilcox, S "Reform of Public Debt Classification Rules Could Free Up More Investment for Housing" in *Social Housing*, November 2009
52 See: *Weaver vs L&Q*, Court of Appeal, 18 June 2009, and subsequent litigation
53 "Osborne's Kill or Cure Budget" in *Financial Times*, 23 June 2010

into line with others, including the rest of Europe, or as a relaxation of resolve to tackle excessive public indebtedness and/or a sign of underlying financial weakness in the UK public finances. It is right for UK commentators to raise the debate on what is clearly an important issue, but it must be recognised that from government's perspective the impact of change on housing investment or even broader local authority trading activity will pale into insignificance compared with broader questions about financial stability.

Conclusion – towards constructive engagement with government

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A changed world

The affordable housing world has changed radically in the space of some three years in terms of both expectations and performance. In 2007, the last comprehensive spending review was set out against what appeared to be a sound economic base. Mortgages were in plentiful supply and government investment in housing was set to grow, though with strong pressure to lever in increased private investment and to maximise the possibilities of realising profits from sales of homes on an apparently permanently rising housing market.

Three years on, affordable housing developers find themselves in a situation in which all housing development is at depressed levels, with lack of mortgage finance constraining demand, particularly for those on lower incomes and those requiring higher loan-to-value ratios. The housing market has declined too, with prices and transaction numbers well down on peak levels and signs that the recent mini-recovery in prices is faltering.

The previous development strategy, based on a combination of lower grant rates and cross-subsidy through open-market sales, is widely believed to be broken. Development levels have been falling, reflecting a lack of confidence not only in the model itself but also in the wider economic prospects for the UK and in the likely levels of future government investment.

The development situation was deteriorating even before the general election settled the speed at which the burgeoning government deficit was to be brought down. The total deficit reduction package as outlined in the emergency Budget is now estimated to be £113 billion in 2014/15, rising to £128 billion in 2015/16.[54]

Cuts and cost saving measures will potentially affect affordable housing development in several ways:

- by having a direct impact on grant levels for subsidised development, thus cutting the number of viable schemes and increasing risks for HAs;
- by raising the prospect of limits to housing benefit expenditure in the social rented sector and changes to the way the benefit is calculated and

54 Ibid

administered – this could have a profound impact on the appetite of lenders and capital market investors to fund the affordable housing sector on the terms prevailing at present;
- by creating a climate of uncertainty about the effectiveness of the regulatory regime for both HAs and local authorities – again, there are risks in relation to the cost and availability of private finance; and
- by putting additional downward pressure on the housing market from the broader effect of major cuts in government spending on the economy, at least in the short to medium term.

Constructive dialogue

The effects on affordable housing provision will not be uniform across the country or between potential developers. There are still areas (such as parts of London) where shared ownership is being successfully promoted, and some HAs remain more confident than others. Nevertheless, unless the affordable housing sector enters a constructive dialogue with the government, there is a grave prospect of affordable housing development entering an accelerated decline, with distressing consequences for those reliant on the sector.

Such a dialogue, which should begin in advance of the autumn spending review, needs to focus on two main themes:

- securing agreement to move towards a new overall strategy for future development, focusing on tenure and how development is to be funded; and
- working together to ensure that within the broad parameters of government determination to cut the Budget deficit, particular expenditure cuts or cost saving measures should not unnecessarily exacerbate the challenges facing the affordable sector.

Key issues

Within the main themes articulated above, there are a series of key issues to be addressed and which have been identified in this paper:

- exploring the prospects for shifting development away from general-needs and low-cost home-ownership housing towards market renting, with the aim of maximising the build rate with minimum grant;
- modelling the effects of allowing rent levels in the sector to rise, in order to maximise cash flows in the interests of future development;

- working towards an approach to housing benefit reform that recognises some key features of housing benefit in the social sector which underpin present and future private investment in the sector;
- recognising the role of sound HA and local authority regulation in securing private funding at low rates and ensuring that the Homes & Communities Agency, as regulatory successor to the TSA, has the necessary focus on financial viability and governance of organisations, possesses credible enforcement powers and has the resources to make scrutiny and enforcement effective; and
- enabling local authorities to fulfil their potential to secure investment as affordable housing developers and examining the case for government to use international standards to classify public borrowing in order to allow local authorities to borrow more freely against their assets to fund future development.

Bridging the gap?

Satisfactory resolution of the issues set out above will go some way towards bridging the gap between the 60,000-plus homes a year that seemed like an achievable development level a short time ago and the low and declining levels that are likely to be in prospect as things now stand. It would be disingenuous, however, to suggest that the gap can be fully bridged.

In the current economic environment and with a depressed housing market, HA development appetite is likely to remain constrained, particularly in the light of experience over the past three years. In addition, as this paper has suggested, none of the alternatives to current models and approaches are panaceas. Market renting will not be a solution for all developing HAs in all markets. Rent rises will not be practical across the board without incurring unforeseen results. It is certainly not a foregone conclusion that definitions of government borrowing can be altered to unlock the development potential of local authorities. There will be a price to be paid in lost development under almost any conceivable strategy in current conditions.

In assessing the scale of lost development, the subjective factors of HA confidence and appetite are most important. Confidence and appetite to develop were in decline even before recent coalition announcements. The announcements by the chancellor and housing ministers have undermined that confidence further.

Even if partial solutions such as those discussed above are agreed, it will be a significant time before many HAs again believe that government can be relied on to maintain its vital support for the development process. Much damage has been done, and the comprehensive spending review can do little more than offer a first step in rebuilding trust, confidence and appetite to take risks that do not form part of the "must-do" HA agenda.

The price of change

Even if a decline in development numbers is significantly mitigated, there will be a price in terms of the social consequences of change. There will almost certainly be less general-needs development, and this will inevitably make the position of low-income people not in receipt of benefits more difficult. A move towards higher rents and more market renting will not only hit the working poor but will make any transition from benefits to work more painful.

A lower grant environment will also inevitably involve more reliance on local markets and less needs-based strategic planning in the disposition of affordable housing development. Clearly, any increase in the level of affordable development will be welcome, but many will view the cost as a move away from many of the social objectives, such as mixed communities, that have informed HA and local authority housing activity.

This paper proposes an approach that mitigates some of the effects of a new economic and financial environment. In the final analysis, a society obtains the housing that it believes it can afford. We achieve what we aspire to and get what we deserve. The forthcoming comprehensive spending review provides an opportunity for government to demonstrate what it believes we deserve.

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