IN NO UNCERTAIN TERMS – SECURING INSTITUTIONAL FUNDING FOR GENUINELY AFFORDABLE HOMES

Jamie Ratcliff

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SUMMARY

While housing affordability worsens in London, more and more is being spent on Housing Benefit payments for tenants living in the private rented sector. Using this funding to build more affordable homes, rather than paying market rents to private landlords, has a powerful logic behind it. But converting 'Benefits to Bricks' is not straightforward, given the scale of up-front investment needed to build more affordable housing.

This paper proposes that Government supports the construction of affordable homes in London by giving a guarantee that Housing Benefit payments will rise in line with inflation for specified new homes, thereby providing investors with the certainty that they need to invest at preferential rates. These guarantees, rising to an annual total of £2.4 billion over ten years, would support the construction of 250,000 affordable homes to rent, enough to house all the Housing Benefit claimants in the private rented sector in London, with rents estimated to be just over half the level of those charged in the market. Government would save money from the point of first occupation and if market rents continued to rise above inflation, the long-term savings could be significant.

The guarantees would be backed by Government, but administered by the Mayor of London. This would allow the housing delivery to be commissioned in the right locations across London, as part of sustainable mixed income communities.

CENTRE FOR LONDON

BACKGROUND AND CONTEXT

There can be no doubt that London is facing a housing crisis. Buying or renting a home in London is already expensive and becoming increasingly unaffordable for the people that live here. In the year to June 2016 average house prices in London rose 12.6% to £472,000.[1] Private rents increased three per cent in the year to June 2016[2] and median market rents now stand at £1,452 per month. Centre for London's Intermediate Housing Commission report *Fair to Middling* has shown that secure and stable housing is out of reach of an increasing number of Londoners on professional salaries.

High housing costs are common to many successful world cities with constrained supply. But in order to sustain success it is vitally important that lower-income households continue to be able to live here. Recent research from organisations as diverse as Centre for London[3], Grant Thornton[4], London First[5] and the Confederation of British Industry[6] has strongly made the case for investment in affordable housing to maintain the current social mix of the capital and retain workers essential to the economy.

For much of the last century, building affordable housing was a major priority for local and metropolitan government in London. From the 1920s to 1960s affordable housing made up large proportions of London's housing supply, largely built by the London County Council, the Greater London Council and local authorities. From the 1980s onwards the majority of affordable housing has been built by housing associations, although volumes are far below historical averages, or the level of affordable house-building that the London Plan says is needed.

1 ONS (2016), *House price index by English region.*
2 ONS (2016), *Index of private rental housing rental price (IPHRP) in Great Britain,* results: June 2016.
3 Travers T., Sims S. & Bosetti N. (2015), *Housing and Inequality in London.* Centre for London.
4 Grant Thornton (2016), *London employers and assistance to employees with housing.*
5 London First (2016), *Homes for Londoners. A blueprint for how the Mayor can deliver the homes London needs.*
6 Centre for Economics and Business Research (2016), for CBI and Peabody, *The business case for affordable housing.*

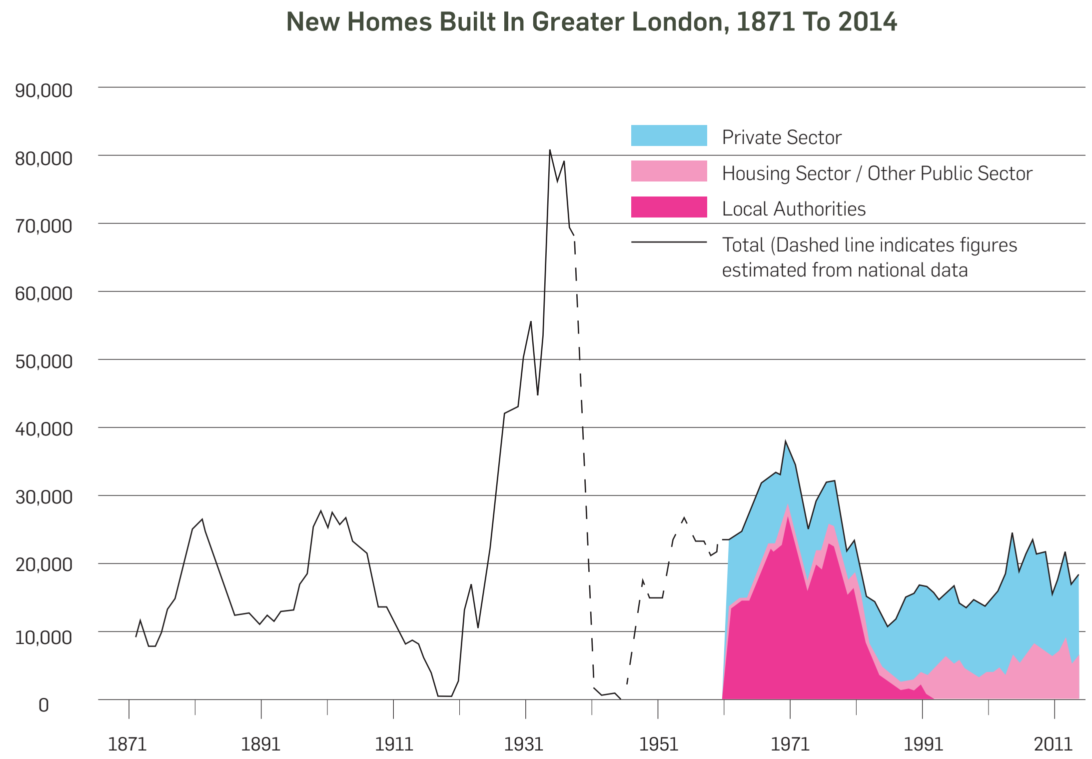

Figure 1 - Reproduced with permission of the Greater London Authority

In recent years, the focus of intervention has shifted from low-cost rented housing to support other types of 'affordable' housing. The 2015 Spending Review and Autumn Statement announced what Treasury press releases[7] claimed to be a doubling of funding for affordable housing. This funding was overwhelmingly focused on affordable home ownership, including products like 'Starter Homes' for which it is estimated that buying a typical home would require an income of £62,000 a year.[8] In contrast, new low-cost rented homes would represent less than seven per cent of the total.[9] Sadiq Khan, the Mayor of London, has been strongly making the case to Government that a higher proportion of delivery in London must be at sub-market rents but it is highly unlikely that current policies and funding mechanisms will be able to deliver the low-cost rented homes the capital needs.

7 Press briefing issued by HM Treasury on 24 November 2015.
8 Mahmoud S. (2016), *Who can or can't afford a Starter Home? It's debatable.* Shelter Policy Blog.
9 HM Treasury (2015), *Spending Review and Autumn Statement 2015.*

This paper proposes a model by which the provision of genuinely affordable homes in London could be boosted significantly over a decade, funded by private long-term investors, without any change to Government's current capital spending plans.

CURRENT POLICY: BENEFITS MORE THAN BRICKS

While Government spending on building affordable housing has diminished, expenditure on affordable housing has risen rapidly when housing benefit is taken into account. In the year to March 2015 nearly £25bn was spent on Housing Benefit in Britain, over £9bn of which was used to support tenants living in the private rented sector, double the amount spent on such tenants in 2005/06.[10] In London, total of £6.25bn was spent on Housing Benefit in 2014/15, this is almost 15 times bigger than the average annual capital investment made available for new affordable housing in London in the 2015-18[11] period.

Not only does pouring £9bn a year into the coffers of private landlords offer little in terms of return for the public purse, but it also fails to give housing the long-term investment it needs. Housing is a vital part of our infrastructure, and is too important to entrust to a range of predominantly amateur landlords, over five out of six of whom are unaware of their fundamental legal responsibilities.[12]

The current Government has attempted to control housing benefit expenditure by limiting entitlement and imposing four years of rent reductions in the social housing sector. Freezing rents may help existing tenants, but does nothing to meet the massive and rising need for affordable housing; indeed, by making it harder for housing associations to secure borrowing against their rental income, it may do the opposite. Despite all of these reforms, the direct result of which is to make it harder for lower income Londoners to live in the city, expenditure is still rising.

It is right to argue that funding would be better spent on new supply rather than housing benefit – 'benefits to bricks'. But building social rented homes for the almost 250,000[13] households claiming housing benefit in the private rented sector in London would cost over £56bn, of which it is estimated that Government

10 National Housing Federation (2016): *The growing Housing Benefit spend in the private rented sector.*
11 £1.25bn over the three years, so an annual average of £417m. *The Mayor's Housing Covenant: 2015-18 Programme.*
12 The 2010 Department of Communities and Local Government Private Landlord Survey of just over 1,000 private landlords and agents found that 85 per cent of landlords were unaware of the Housing Health and Safety Ratings System.
13 See Annex Two for more information.

would need to provide at least half.[i]

Nor can housing associations solve the problem alone. Due to decreasing levels of grant funding, ongoing rentreductions, and limits on the funding which their investors are prepared to advance to them, housing associations have had to become increasingly commercial. A number of the largest housing associations now develop around half of their homes for open market purposes to cross-subsidise affordable housing. This model leaves housing associations vulnerable to market cycles and unable to play a counter-cyclical role as they have done in the past.[ii]

Providing long-term certainty on rents would allow all of these problems to be addressed, levering in long-term private sector investment to build the genuinely affordable homes that Londoners need.

LONG-TERM PRIVATE SECTOR INVESTMENT

There are already signs of growth in private sector long-term investment into the 'build-for-rent' sector. Such developments are attractive to investors, like pension funds, who prioritise long-term income streams. There is an estimated £3tn of potential investment interested in UK residential.[14] This is enough funding to build 12m homes, enough supply for almost 470 years of affordable housing supply at the level needed. Less than two per cent of this total would be needed to fund the construction of 250,000 affordable homes to rent.

Large well-known pension funds such as Legal & General, Aviva and Prudential have publicly expressed their desire to invest in housing. Public sector pension schemes including those for London and Lancashire have done the same. Long-term investment into housing by similar institutions is already widespread in a number of countries, facilitated by experienced property managers and developers. Many of these companies, some of them American like Related, Greystar and M3 Capital Partners, are actively looking for opportunities in the UK.

These investors are generally less concerned with short-term changes in house prices and are able to let their homes quickly as their tenants can move quickly without the need for mortgage approvals, valuations or conveyancing. Building at scale minimises the impact of tenant churn and the subsequent void risk. These factors combine to suggest that homes can be absorbed into the market ten times faster[15] than those for sale, meaning homes can

14 Ratcliff J (2016) *Mass-delivery of manufactured homes for rent* Policy Exchange
15 Based on press releases on the Get Living London website where the gap between the 100th property let and the 1,000th was 214 days, a letting rate of 1,536 homes a year.

be built more quickly by such providers than through traditional housebuilder business models. However, the homes delivered by such providers are typically in the top 25 per cent of rents in their local markets, which means that they are not affordable for Londoners on low to moderate incomes and are unlikely to be able to be covered by housing benefit due to current restrictions on Local Housing Allowance.

Whilst the 'build for rent' model favoured by institutional investors has the potential to significantly increase overall housing supply, it will do little on its own to provide genuinely affordable homes for Londoners. There is, however, potential for a model of institutional investment that can pay for genuinely affordable homes to rent and buy.

THE GUARANTEE

A long-term, binding government guarantee for housing benefit to cover rents on specified new homes, rising with inflation, would unlock long-term private investment to cover the full cost of building these homes. Where an investor is fully protected from inflation, they will accept lower initial returns, which will become more valuable to them over time. Given rents in the private and social sectors have traditionally risen above the rate of inflation there may be no real cost to Government of giving such a guarantee.

The guarantee would be a binding 60-year guarantee that the initial rent and ongoing increases at the rate of Consumer Price Index (CPI) inflation would be met in full by housing benefit, or successor benefits, when occupied by eligible households. Indexing to the CPI would fix the cost in real terms for Government and in all likelihood represent an ongoing, increasing saving if rents in the private sector continue to rise at a faster rate.

Once fully let, it is estimated that the 250,000 homes would require a Government guarantee of Housing Benefit of up to £2.4bn a year.[iii] This would be the total rent payable on the homes if eligible low-income household occupied them.

Delivering affordable housing at this scale requires effective management. It is proposed that this would be devolved to the Mayor of London to be managed alongside, but in addition to, the capital programme of affordable housing investment currently being negotiated with Government. The Mayor would oversee negotiation of starting rents based on a percentage of the total capital costs, and rigorous scrutiny of these costs to ensure value for the public purse.

It would be likely that the programme would take a few years to gear up to delivering 25,000 affordable homes a year, but on average it would require ongoing increases in guarantees of £240m a year to be agreed over the ten year period. Once fully let it is estimated that these low rent homes would reduce Housing Benefit expenditure by almost £600m per year compared to the rent that would be paid in the private sector.[16]

As rents would be linked to cost, they would vary transparently in relation to size of the home and its location. It would mean that the rents charged would be higher or lower according to the relative costs of construction and land. This investment into affordable housing would be brokered by the Mayor, and underwritten by Government.

RENTAL LEVELS

The rate of return required by long-term private investors will effectively set the rent levels of the new low cost rented homes. Expectations of returns are currently at near record lows due to low long-term interest rates globally. This is one of the factors that makes this proposal so attractive for implementation in the near-term as it would be enable homes to be built at rental levels significantly below the market and only slightly above social rent levels.

In order to model the rents that would be required to support this model we asked three long-term investors, all currently exploring investment into residential, and two intermediaries working with a wider range of funders, to provide the funding rate they would require across three scenarios, assuming full funding of development costs.

The level of return varied depending on whether the full initial funding advance would be outstanding for the duration of the guarantee, so the rent would need to support the interest payments only, or if the principal would also be repaid through amortising payments (essentially, the difference between interest-only and repayment mortgages). If payments were amortised, Government could realise a share of the asset value at the end of the term. As is to be expected the investors and intermediaries reported different expectations of return but the spread was relatively tight with a maximum variance of 90 basis points (0.9 per cent).

Due to the relatively low variation in expectations of return the variance in total cost of constructing an affordable home has a much greater impact on rental level. The impact of a wider spread of funding costs and different average construction costs has been modelled and is presented in Annex One. In all modelled scenarios

16 See Annex Three.

the rent would be below current average London market rents.

An average expected rate of return of 2.93 per cent per year on an average total cost of constructing an affordable home of £225,000 has been used. Allowing for management, maintenance, bad debt and voids it is estimated that the average total cost of an affordable home in London could be financed with a rent of £186 per week (44 per cent less than market rents[17], just a little bit more than social rents[18], which are on average 52 per cent less than market rents).

THE LONG TERM IMPACT

To provide certainty, it would be essential that the guarantee was contractual and could not be amended by future governments for homes that had already been built. It is proposed that the provision of the guarantees would be a one-off investment to boost the level of genuinely affordable housing in London, over a ten-year period. Once signed the guarantees would provide sixty-year certainty to investors. The economic case for new rounds of guarantees would vary according to interest rates sought by investors, inflation, volumes of low income households and the cost of borrowing for Government itself.

For this model to deliver the scale of low cost rented homes needed in London would require investment of £56bn from long-term investors and a guarantee from Government, once all homes were fully let, of up to £2.4bn per year. In reality this would not be an additional cost to Government, simply a switching of some of the housing benefit paid to households living in the private rented sector. As the rents would be significantly below those in the private rented sector there would actually be a saving to Government of an estimated £600m[19] a year in the initial period.

This saving would only become a cost to Government only if rents in the private rented sector rose at below CPI in the long-term, given starting rents in this model are 44 per cent below median market rents there is a considerable buffer built in to protect against this risk. Though Government is currently pursuing a policy of freezing in nominal terms the rents payable through housing benefit, this policy is not be sustainable in the long-term, without significant negative impacts on low income households. It is more likely that housing benefit in the private rented sector will rise above CPI in the long-term as it has in the past in both the social and private rented sectors.

17 At £333pw - £1,452 per calendar month, see footnote two.
18 See Annex Three.
19 See Annex Three.

The guarantee would be a powerful and attractive incentive for housing providers to focus on low-income households when building homes for rent. Investors could be encouraged to invest in a range of tenures, including homes for market rent and shared ownership, to create mixed and balanced communities housing people on a range of different incomes and these models could co-exist alongside mass investment in market rented homes.

LAND AND DEVELOPMENT OPPORTUNITIES

Finding land and development opportunities for the 250,000 affordable homes envisaged by this model over ten years will be a significant challenge. The challenge will be even greater if these affordable homes are to be located in mixed income communities alongside a larger number of market rented homes and shared ownership homes, as this paper proposes. It is likely that alongside the provision of guarantees there would need for muscular intervention from the Mayor and his agencies, in site assembly, designation of suitable land and creation of development opportunities in order to build the homes that Londoners need. At the same time, the construction sector workforce would need a major boost in numbers or productivity to move beyond its current output, which has been more or less 20,000 homes per annum since the 1980s.[20]

CONCLUSION

London has a clear and pressing need for housing that is affordable both for the occupants, now and in future, and in terms of public expenditure. This model, combining using guaranteed support, through Housing Benefit, for low cost rent to unlock investment from the private sector can finance the affordable homes that London needs, whilst delivering savings to the public purse.

20 Department for Communities and Local Government *'Live Table 253 Permanent dwellings started and completed by tenure and district'*

ENDNOTES

i Based on current social rents and the current deliver model housing associations are able to borrow around £100,000 against the average social rental stream in London, compared to costs of an average of £225,000. Housing associations could reasonably be expected to add to this with cross-subsidy from existing social rented homes and commercial activity but at this scale that, and their overall ability to borrow would be diminished, implying a need for higher levels of Government capital subsidy.

ii The housing association model was further undermined by measures in the July 2015 budget to introduce four years of one per cent rent reduction on all social landlords, including housing associations. This was expected, by the Office of Budget Responsibility to reduce housing supply by 57,000 affordable homes over the period to 2021, and introduce considerable uncertainty to the sector.

iii The average annual rent is calculated at £9,687 per year (£186 per week), inclusive of service charge. Multiplied by 250,000 homes the annual rent roll for all of the properties would be £2,421,722,500 per year. In reality not all of the households would need full Housing Benefit support to cover their rent so the Government expenditure would be lower.

ANNEX ONE – FUNDING RATES FOR LONG-TERM PRIVATE INVESTORS

All investors/intermediaries were asked to assume a Government guarantee behind rental increases and that they would cover up to 100% of initial costs in the below three scenarios. The average of the rates quoted is set out after each scenario.

- *Option one* – Cost of finance rising at CPI each year, servicing the debt on an interest only basis, with full capital repayment in year 60. – Average rate 2.93% (i.e. £1m loan receives £29,300 interest in year one).

- *Option two* - Cost of finance rising at CPI each year, principal amortising over a 60 year period. – Average rate 3.13% (i.e. £1m loan receives £31,300 interest in year one plus some repayment of principal).

- *Option three* - CPI increase to rents every year, properties themselves used as repayment in year 60, free of any encumbrances. – Average rate 2.83% (i.e. £1m equity investment receives £28,300 return in year one).

Option one forms the basis of the modelling in this paper, largely because it will allow the rents to be set lower than option two (due to the lower rate and no ongoing repayment of principal) and is simpler to operate than option three (it can be structured as a loan, although this does not mean that it could not be structured with equity investment and ownership by long-term funders).

The three tables below set out weekly rent levels that would be required to achieve the relevant rate of return, guaranteed over sixty years. In all cases it is assumed that 25% of the gross rent (not including service charge) would be required to cover voids, bad debts, management and maintenance.[21] For the amortising option it is assumed the principal amortises over sixty years.

21 This is considered to be a conservative estimate as the service charge would be available to cover a range of management and maintenance expenditure.

Assumed total construction cost of £225,000

	2.50%	2.93%	3.13%	3.50%	4%
INTEREST ONLY (£)	160.76	185.49	196.99	218.27	247.02
AMORTISING (£)	184.13	204.28	213.93	232.21	257.67

Assumed total construction cost of £275,000

	2.50%	2.93%	3.13%	3.50%	4%
INTEREST ONLY (£)	192.71	222.93	236.99	262.99	298.13
AMORTISING (£)	221.27	245.89	257.69	280.03	311.15

Assumed total construction cost of £300,000

	2.50%	2.93%	3.13%	3.50%	4%
INTEREST ONLY (£)	208.68	241.65	256.98	285.35	323.69
AMORTISING (£)	239.84	266.70	279.57	303.94	337.89

ANNEX TWO – HOUSING BENEFIT CASELOAD AND EXPENDITURE

Number of Housing Benefit claiming households in London by tenure[22]

	SOCIAL RENTED SECTOR	PRIVATE RENTED SECTOR	ALL HOUSING BENEFIT CLAIMANTS
INNER LONDON	307,533	182,677	392,867
OUTER LONDON	236,542	166,660	403,199
ALL LONDON	544,061	249,432	796,048

Housing Benefit expenditure in London[23]

	2010/11	2011/12	2012/13	2013/14	2014/15
LONDON HOUSING BENEFIT EXPENDITURE (£BN IN NOMINAL TERMS)	5.54	5.89	6.08	6.12	6.25
TOTAL LONDON WELFARE EXPENDITURE (£BN IN NOMINAL TERMS)	18.75	19.51	20.22	19.67	19.90

Comparative cost of Housing Benefit in London by tenure, Feb 2016[24]

	SOCIAL RENTED SECTOR	PRIVATE RENTED SECTOR	AVERAGE DIFFERENCE
WEEKLY AVERAGE AWARD (£)	124	188	64
ANNUAL AVERAGE AWARD (£)[25]	6,479.32	9,809.84	3,339.52

22 Source, Department for Work & Pensions table *'Housing Benefit claimants by Region and Local Authority: by Tenure and Passported Status: May 2015'*.
23 Source, Department for Work & Pensions table *'Benefit expenditure by country and region, 1996/97 to 2014/15'*.
24 The National Housing Federation (2016) Op. Cit.
25 Calculated on the basis of 52.18 weeks in a year.

ANNEX THREE – CALCULATED HOUSING BENEFIT SAVINGS

	WEEKLY RENT	WEEKLY AVERAGE HOUSING BENEFIT AWARD	WEEKLY SAVING COMPARED TO PRS, PER AWARD	ANNUAL SAVING COMPARED TO PRS, PER AWARD
SOCIAL RENT (£)	161[26]	124[27]	64	3,340
GUARANTEED RENT (£)	186	143[28]	45	2,335
PRS OCCUPIED BY HOUSEHOLDS CLAIMING HB (£)	244[29]	188[30]	0	0

Once multiplied by the 250,000 properties proposed in this paper the 'guaranteed rent' is estimated to generate £584m of savings in Housing Benefit a year, compared to the private rented sector.

Greater savings, of £835m a year, could be generated by moving the 250,000 claiming households to social rented homes but this would involve an estimated minimum of £28bn of up-front investment from Government in the form of social housing grant. This calculation is based on the current social rents and the current delivery model for housing associations which enables them are able to borrow around £100,000 against the average social rental stream in London, compared to costs of an average of £225,000. Housing associations could reasonably be expected to add to this with cross-subsidy from existing social rented homes and commercial activity but at this scale that, and their overall ability to borrow would be diminished, implying a need for higher levels of Government capital subsidy.

26 Calculated using the average new build social rent in London in 2013/14 (£153pw) uprated by CPI +1 per cent in April 2014 and April 2015, *GLA Affordable Housing Programme Outturn.*
27 The National Housing Federation (2016) Op. Cit.
28 Calculated assuming the same relationship between the weekly award and rent as social rent (77%).
29 Calculated assuming the same relationship between the rent and the weekly award as social rent (130%).
30 The National Housing Federation (2016) Op. Cit.

About the author
Jamie Ratcliff is an affordable housing expert with over ten years experience working in senior roles in housing development and policy at a local, regional and national level. He has played a leading role in establishing a number of affordable housing investment programmes. This piece has been written in a personal capacity.

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1 Plough Place
London EC4A 1DE
t: 020 3757 5555
hello@centreforlondon.org
www.centreforlondon.org
Company Number: 8414909
Charity Number: 1151435