CIH submission to the Levelling Up, Housing and Communities Committee on the current state of financial resilience of social housing providers

The Chartered Institute of Housing is the professional body for people who work and have an interest in housing. The select committee's call for evidence in this area is very timely and we are pleased to have the opportunity to respond. We have addressed the questions where we feel able to give an informed view. We would welcome the opportunity to expand on these points if called to give oral evidence.

The current state of financial resilience of social housing providers:

1. *How would you assess the financial resilience of the social housing sector currently? Are increasing pressures and requirements putting financial viability at risk?*

The latest Global Accounts for 2022 demonstrate a resilient financial performance in the face of testing economic and operating conditions. However, deteriorating margins, lower levels of interest cover and reduced capacity to manage downside risks are indicative of the challenges the Regulator expects providers to face in the future. The pressures are considerable, as we outline below. While at the margins, this means there is a risk to financial viability, the sector's recent track record has been good in this respect, with only one provider needing to be refinanced via merger in the recent past.

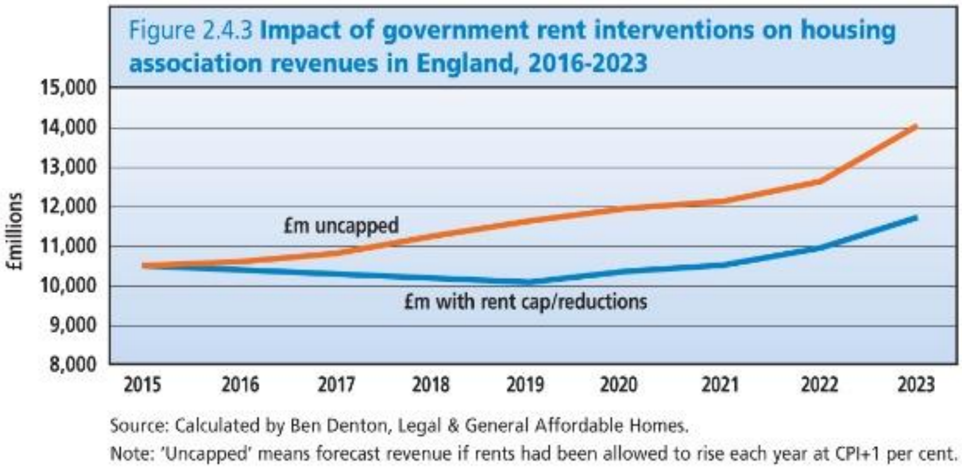
Local authorities' position is also difficult but to an extent they have built-in resilience through their legal requirement to balance their housing revenue accounts (HRAs) and raise income or cut costs accordingly. They are, however, subject to greater political pressure at local level to restrain rent increases.

Overall, it is difficult to see any substantial increase in the risk of <u>actual financial failure</u>: it is much more a case of organisations tightening belts and reducing their commitments, with perhaps some likely increase in merger and stock transfer activity as a result. One provider typically commented that it now takes a "more pessimistic view of the world" and hence stress-tests for risks which would not have been considered a short time ago. "Risk appetite" is now as important as financial capacity in deciding levels of activity.

2. *What pressure has high inflation, increased energy costs and any other additional costs placed on the finances of social housing providers?*

The government put a seven per cent cap on rent increases for 2023/24; while understandable during the cost-of-living crisis, this means, once again, that rents will not keep pace with cost increases. There is a cumulative impact on the sector's ability to invest, both in new development and in the existing stock.

Impact of government rent interventions on housing association revenues, 2016-2023:



Source: UK Housing Review 2023; calculated by Ben Denton, Legal & General Affordable Homes.
Note: 'Uncapped' means forecast revenue if rents had been allowed to rise each year at CPI+1 per cent.

A chart from the *UK Housing Review 2023* shows the impact on housing associations' income of restrictions on rents over the period since 2015/16. Income was lost from four years of obligatory 1% reductions and further income will be lost from the below-inflation cap on rent increases for 2023/24. The cumulative impact of these two policy restraints, compared with rents rising at CPI+1%, is to remove 20% of rental growth from the sector over an eight-year period. For housing associations this is equivalent to a loss of £2.3 billion, which could have levered in £40-50 billion of new investment. Looking specifically at the picture for 2023/24, in its assessment for CIH of the effects of a 7% cap on rent increases in December 2022, Savills projected real average cost increases of 10% for social housing providers (taking into account staffing, materials, contractor, energy and other costs). Local authorities' projected net loss of resources resulting from the cap was up to £300million – equating to between c3-5% of all operating costs (management, maintenance and major repairs) and c5-7% of operating expenditure excluding major repairs. Housing associations' projected net loss of resources was up to £400million – equating to c3-5% operating expenditure or loss of interest cover of up to 5-10bps.

Providers stress that risk arises from a combination of factors and that although some are common (e.g. cost inflation) the significance of others will vary from one provider to another (e.g. building safety issues or exposure to a weak sales market).

Providers also emphasise the attention being paid to their residents' cost-of-living problems, ie. trying to ensure that housing-related costs such as energy are affordable, as well as rents. An example is some providers installing solar PV to generate electricity to power otherwise expensive heat pumps, which are replacing gas boilers.

3. *To what extent can social housing providers maintain output levels in housing development to provide a counter cyclical balance in otherwise tightening market conditions?*

The current trend, in response to other pressures, is to cut new development. To some extent this is already reflected in DLUHC projections relating to the Affordable Homes Programme. The DLUHC 'central' forecast is now that 157,000 new homes will be completed under the AHP 2021-26, considerably fewer than the 180,000 originally planned.

The AHP 2021-26 target assumed that the rent policy which began in April 2020, of increases based on CPI+1 per cent, would still apply. The Public Accounts Committee pointed out that the achievement of the AHP targets for new homes is at 'significant risk', especially because of 'large increases in the cost of materials and labour'. The capping of rent increases is likely to affect overall affordable output by limiting the extent to which providers can fund new homes from non-grant sources.

There have been several warnings about expected cuts in output. For example, the GLA and the G15 group of large housing associations issued a joint warning on the threats to new build programmes; numbers of individual providers have announced cuts in their new build targets. A survey of local authorities gave a mixed picture: 44% are reducing their housing capital programmes and a quarter said they had been halted altogether; others are making no cuts.

There is an implicit question as to whether providers could again buy properties on the open market, using special government funding, as happened in 1992/93. There is a recent precedent in the GLA's support for councils to acquire more than 1,500 former right-to-buy properties. Undoubtedly such a programme could be made to work, if funding recognised the required investment not only in acquisition but in improvement or, for off-the-shelf new build, for improved energy efficiency where needed. One member commented: "We need to support our contractor partners to keep delivering more affordable homes and can ill afford any more to go into administration because it will have serious consequences for the delivery of the 2021-26 programme."

4. *What impact have changes in the housing market in recent years had on the strength of housing associations' balance sheets?*
5. *Does the cross-subsidy model, by which market housing helps pay for social and affordable housing, have any continuing viability?*

In previous downturns, HAs were less reliant on their own market sales, although of course the impact of housing market changes depends on the extent to which a provider relies on them. A tighter market both reduces the cross-subsidy available and makes providers more cautious and more risk-averse. The cross-subsidy model is now a smaller driver in a faltering market, rather than one that has ceased to be viable at all. However, the dependency on cross-subsidy has been one of the drivers behind reduced output of homes at social rents (which require direct subsidy through higher grant).

6. *To what extent have private equity investors, and in particular international investors, been entering the sector? What challenges does this present?*

The *UK Housing Review 2023* sets out in detail the considerable scope for increased equity investment in the sector arising from the massive interest from investors worldwide in UK affordable housing, and growing interest from housing associations in alternative funding solutions. There is a mix of activity and a range of models and there is an emerging market for all types of partnerships. The key market drivers are clear, and despite the challenges of inflation, interest rates and general economic volatility, they are unlikely to fundamentally change, with new equity investors focussing on:

- acquisition of section 106 schemes and grant-funded development schemes
- financing HA development pipelines as associations 'retrench' into asset management on their existing stock (see below)

- acquiring HA assets with management maintained by the HA, releasing capital for HA reinvestment.

Just as occurred with the introduction of private finance in the 1980s which led to rapid growth in debt funding sustained over a 25-year period, the *UK Housing Review 2023* argues that "a new age of equity investment has arrived." There is more detail on this in Contemporary Issues Chapter 3 of the *Review* (attached as an annex at end).

New challenges to the social housing sector:

1. *The Secretary of State has specified that more resources need to be directed towards maintaining and improving the existing stock. How feasible is this for social housing providers?*

Restrictions on rent increases coincide with intense pressure on landlords to invest in their existing stock and indeed calls from local authority landlords for more financial support to tackle a backlog of necessary work. Housing associations reported a record £6.5 billion of spending on their existing stock in 2022, up from £5.4 billion in the previous year. While this reflects some catching-up after delays during the pandemic, it also results from the new emphasis on building safety work. There has also been a significant increase in covenant waivers to support investment in existing stock, especially for decarbonisation work.[1]

While increased investment in the existing stock is welcome, it is also clear that it is insufficient and that priority is likely to be given (correctly) to building safety requirements and to work to tackle other priority issues for the sector, such as damp and mould. Pressures will increase further when the Decent Homes Standard is updated. However, there is considerable concern that resources will be insufficient to meet the new standard, and in particular that insufficient progress is being made towards the government's carbon targets.

2. *How do social housing providers choose whether to undertake new development or to focus on maintenance and upkeep of existing stock? Is it currently possible to achieve both objectives?*

There is some indication of a shift away from new build on undeveloped land towards regeneration of existing estates. In part this is a response to wider recognition of poor quality in existing stock, and the cost of achieving high

[1] Lloyd, M. (2023) 'Covenant waivers continue to rise, as RPs prioritise investment in existing homes,' in *Social Housing,* 12 April.

energy-efficiency standards. One provider pointed out the unfairness of new, high-quality homes going to someone on the waiting list, when current residents may have lived for years in poorer quality accommodation.

3. *What issues does the requirement on Housing Associations to carrying out building safety present?*

In short, (as one provider commented) "it has to be done." This means reduced capacity for other work if no government assistance is available and unless (after delays) costs can partly be recovered from builders/suppliers.

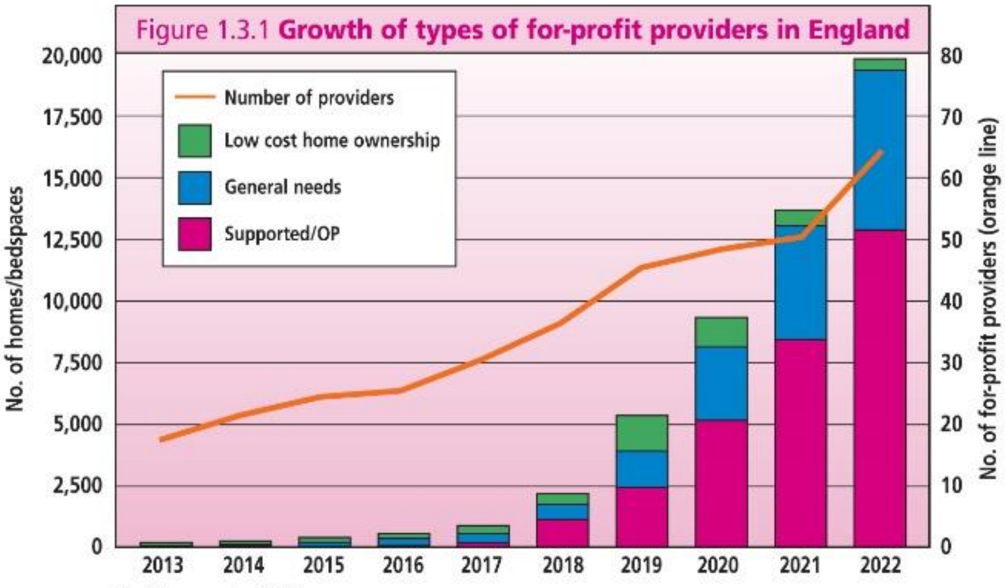
4. *Has the lifting of the cap on the Housing Revenue Account made a difference to supply or improved housing from Local Authorities?*

Local authority capital investment through their HRAs is robust, and represents an important contributor to affordable homes investment. It exceeded £6 billion in both 2019/20 and 2020/21, and in 2021/22 rose to £7.3 billion. This includes some non-HRA capital spending and also spending by the GLA (9% of the total). Borrowing for investment has increased since the removal of HRA borrowing caps in 2018, financed by recent growth in rental income. It remains to be seen if it will continue to grow in 2023/24 now that rent increases have been capped.

Unsurprisingly, however, more of the increased investment appears to be going towards the existing stock. The recent peak year for local authority completions was 2018, when 2,680 homes were built by councils, with output declining to a provisional 1,620 for 2022. The recent announcement about councils retaining capital receipts from right to buy will certainly help to maintain new build output, but there are other restrictions on the ability to reuse receipts, such as that they are limited to providing 40% of the costs of new build. Councils' contribution will therefore continue to be modest, albeit probably focussed primarily on delivering homes for letting at lower, social rents.

5. *Have for-profit Housing Associations made the sector, as a whole, more financially robust?*

By 2022 there were 64 for-profit registered providers (FPRPs) managing 19,600 homes. The number has grown from negligible levels in 2017 (see chart).



Savills research, 2022.

For the *UK Housing Review 2023*, Savills forecast that numbers of FPRPs will grow to approximately 90 by 2027, providing 141,000 homes and investing £26.8 billion in capital. The projection suggests that FPRPs could be providing upwards of 25,000 new homes annually by then, or about half of current output.

Given the nature of such investors (e.g. pension funds), this growth in itself indicates a high degree of financial robustness in the sector, hence its attractiveness. Whilst the changed environment of higher inflation and higher interest rates may be a brake on growth, the same of course applies to other sectors which such investors might consider as alternatives. The one important and unique factor in the affordable housing sector is rents policy, where investors are looking for certainty over at least five years and preferably over a decade.

6. *Traditionally, struggling Housing Associations have merged with stronger, sometimes complementary, Housing Associations. Will this continue to be possible?*

This "rescue" model continues to operate as seen most recently with the merger of Swan Housing Association with Sanctuary Group. There is no in principle reason why such rescues might not be possible in future, although in practice their feasibility is especially contingent upon the receiving organisation having sufficient financial capacity and liquidity to take on any commitments or financial exposures. As operating conditions tighten it is possible that it will become harder for receiving organisations to achieve, especially if the scale of financial commitments and exposures is very large.

7. *Has the emergence of partnership working between councils and housing associations in local areas made the sector more resilient? What encouragement has the Department given to such partnerships?*

CIH examined this issue in depth in its report *Building Bridges* in 2017. It found many examples of partnerships of different kinds, and the report was intended to provide practical guidance on developing such partnerships. The examples ranged from large, strategic partnerships like those covering the whole of Greater Manchester and Sheffield city regions, to more modest ones like the Plymouth Housing Development Partnership and the York, North Yorkshire and East Riding Strategic Housing Partnership with nine district councils, down to single HA-LA partnerships such as that between Sovereign and West Berkshire Council. In all these cases, and others examined, there appeared to be strong evidence of positive effects on housing delivery.

It should be said that DLUHC's role in promoting partnerships has been limited: for example, it is only now proposing some devolution of funding to larger partnerships. There is scope for this to go further, especially where all providers in the area covered by the partnership are members of it (as in examples just noted).

Such partnerships undoubtedly strengthen HA-LA collaboration in planning housing development, and the motivation behind the report *Building Bridges* was to promote them more widely by showing multiple examples of how they can be made to work.

8. *The Affordable Homes Programme includes a high proportion of shared ownership properties. To what extent is this form of tenure desirable for potential purchasers and for social housing providers?*

Shared ownership (SO) works in some areas and not in others. Also, the recent changes to staircasing and repair obligations have made the tenure less desirable for providers. SO is by design open to a wide spread of incomes yet remains inaccessible to around three-quarters of low-income renters.[2] The *UK Housing Review 2022* concluded that "SO needs further reform if it is to become the ever-more-important route into affordable homeownership that policy has ascribed to it and that the market wants and needs."

[2] Elliott, J. and Earwaker, R. (2021). *Renters on low incomes face a policy black hole.* York: JRF.

9. *What contribution have council owned housing companies made to increasing social housing supply?*

These companies reportedly exist in some form in four-fifths of local authorities, and add to affordable (as well as market) output. Data on numbers of homes delivered are not reported separately, nor do they necessarily appear consistently as 'local authority' provision in national datasets, since individual councils decide (using DLUHC guidance) how to categorise them in making their statistical returns. This makes it difficult to give an overall picture of their impact.

Some data on output has been provided by the reports on Local Authority Direct Provision of Housing by Janice Morphet and Ben Clifford, but their 2021 report indicated output of over 20,000 homes (presumably over several years), which is difficult to reconcile with figures on councils' output recorded in DLUHC statistics. Further work is therefore needed to determine the effectiveness of local authority companies.

The recent collapse of the Croydon company may indicate a weakness in this sub-sector, but given the variety of different arrangements and the widely differing degrees to which such companies have delivered at any scale, their vulnerability is difficult to predict.

10. *Will the introduction of the Infrastructure Levy and changes to section 106 significantly affect the capacity to develop affordable housing?*

Yes. We have significant concerns that the Infrastructure Levy (IL) will affect delivery of affordable housing, particularly social rented housing, leading to a potential diversion of developer contributions towards other unspecified forms of expenditure. Given increasing pressures on LA funding, we are worried that the IL could be used to 'plug gaps' in other areas of local authorities' tightly stretched budgets.

The section 106 system is not perfect, but it is an extremely important source for delivery of affordable homes. In 2021/2022 more than 26,000 affordable homes were delivered via s106 without grant (44% of all affordable output). S106 is a well understood tool by LAs, developers and providers, and at its best creates genuinely mixed communities with a range of housing types and tenures.

While "at least as much" affordable housing is promised with IL, there are no meaningful protections for this in proposed legislation. Indeed, evidence suggests that the greatest value will be captured in high-value greenfield locations, leaving serious concerns about the ability to capture value on brownfield land and in low-value areas. In some areas, setting rates at the level needed to maintain current levels of affordable delivery could make developments unviable. Alternatively, setting rates at a low-enough level would result in less value capture and lower affordable supply. Local authorities would be encumbered by a complex system unresponsive to differences in land value and site viability and resulting in a fall in affordable homes delivered.

A great strength of s106 is that it facilitates a well-integrated mix of housing tenures. A finance-based system could undermine this. The government has recognised this risk to an extent, but the protections it offers depend entirely on regulations, with promised flexibilities that are concerning, e.g. that LAs "should not be obliged to seek their full entitlement of on-site affordable housing, enabling them to redirect Levy resources towards other infrastructure priorities". There are also concerns around ensuring that the 'affordable' housing being delivered through IL is genuinely affordable.

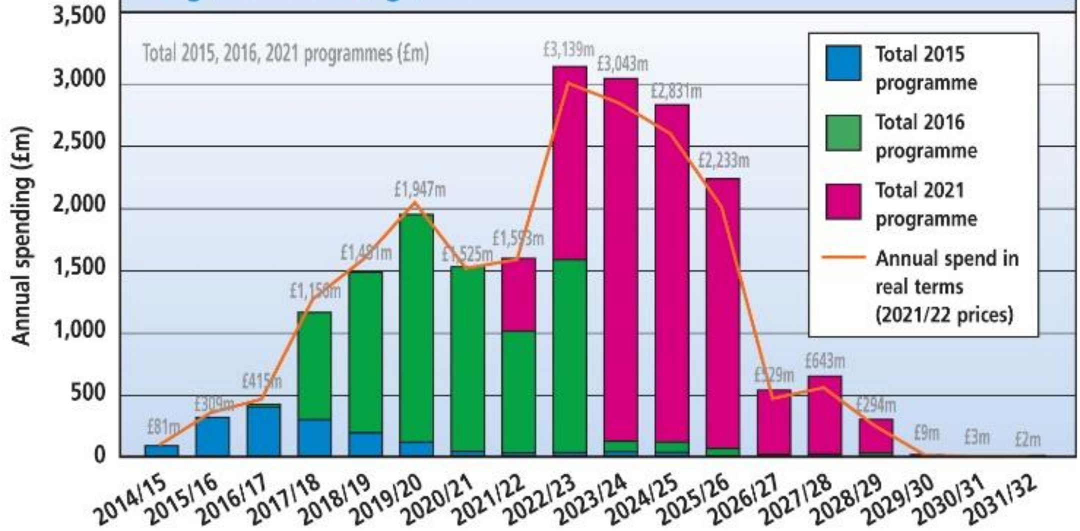
What are the policy and regulatory challenges to the Department and the Regulator?

1. *Is the current Departmental policy on social housing and affordable homes appropriately focused?*

The recent NAO report on *The Affordable Homes Programme since 2015* made several criticisms of the Department, centred particularly around overall performance in meeting AHP targets. The fact that revised targets are not made public is certainly a concern, especially given the effects of the pandemic on house building, which meant the targets needed to be revisited. It would be helpful if there were more transparency here.

Another criticism is that the Department and the Treasury should provide more consistent levels of resourcing for affordable housing. The chart shows the combined effects of recent programmes, based on data from the NAO, and indicates a distinct peak in funding, with providers facing considerable uncertainty about levels of funding just 2-3 years ahead.

Figure 2.4.2 **Actual and forecast spend under Affordable Homes Programmes in England**



Source: Data from National Audit Office, The Affordable Homes Programme since 2015.
Note: '2015 programme' is the Affordable Homes Programme 2015–18, the '2016 programme' is the Shared Ownership and Affordable Homes Programme 2016-21 and the '2021 programme' is the Affordable Homes Programme 2021-26.

Another criticism is that rents policy is out of date and ad hoc, with for example an archaic formula for calculating social rents. An updated and simplified rents policy, together with more long-term certainty about rent levels, would help providers considerably, including to develop more homes for social rent.

2. *Is Homes England (HE) being directed appropriately by the Department, and is it achieving its objectives?*

Providers have commented to CIH that the current Homes England programme does feel both tighter and more onerous from a provider perspective. They also report that current economic and housing market volatility is beginning to really test the flexibility of some systems and processes to respond.

An important criticism in the NAO report is the inadequate monitoring data provided by HE and, to a lesser extent, the GLA. For example, HE's quarterly reports under the previous AHP became very intermittent, and under the current AHP have not yet been produced. It would be helpful if detailed, and compatible, quarterly reports were produced by both bodies.

4. *Is the current range of grant funding available appropriate to address the issues and challenges that the social housing sector faces?*

There is insufficient understanding of the role played by grant, with the Regulator of Social Housing suggesting in 2020 that by 2022 it would only provide about six per cent of investment funding. Of the affordable homes completed in 2021/22, just 42% were grant-funded. The NAO's assessment of dependency on grant is (unhelpfully) specific to those homes which are grant-funded, and shows that, under the current AHP, grant accounts for 25 per cent of costs in those cases. Debt accounts for the biggest share, at 46 per cent, with the remainder paid for from capital receipts and other sources.

Perhaps because of a lack of understanding of their precise role, grant levels appear to be rather arbitrarily decided, and certainly have had the effect of constraining the output of homes for letting at social rent, the stock of which has fallen by 218,000 homes in a decade (mainly through right to buy and conversion of lettings to Affordable Rent). The current AHP will deliver only around 33,500 homes for social rent over five years, very far below the numbers needed (90,000 annually, according to the last comprehensive assessment by Glen Bramley). Grant levels also affect quality of building: trimming costs to achieve grant criteria will inevitably lead to future problems.

5. *On our inquiry into exempt accommodation we found that issues have arisen when providers are not registered with the Regulator. How does the Regulator of Social Housing engage with Housing Associations whose registration is voluntary?*

Registering with the Regulator is voluntary for all private bodies regardless of size. However, the worst cases of abuse have occurred where the provider is registered and the provider is using the benefits of registration to evade regulatory standards – such as HMO standards that would otherwise be required.

Unregistered HAs are typically small in most cases (typically 200 hundred homes or fewer) and it is not clear what benefits would accrue to either party (and to tenants) from registration – apart from smoothing the way for the higher rents awarded in exempt accommodation because the rent is not referred to the Rent Officer.

We are not aware of any evidence that unregistered HAs are more or less likely to be involved in abuse or unsatisfactory standards around exempt accommodation than registered ones. But some of the most blatant abuse (such as in Birmingham) occurs when organisations register to gain a regulatory and financial advantage. One example is providers who register as non-profit with a small number of general needs units, who then charge market rents on a much larger portfolio of supported exempt accommodation, which not being 'social housing' then falls wholly outside consumer regulation and the rent standard. The Regulator's engagement is then effectively limited to issues around financial viability when the most pressing issue may be standards.

10. *It is already accepted that the numbers of dwellings likely to be produced under the 2021 Affordable Homes Programme will be less than initially forecast. Will the financial challenges that the sector faces reduce these numbers even further?*

Numbers will show a substantial shortfall (see above), and there is a significant risk of numbers falling still further, given current pressures. Clearly, output was already below numbers needed, especially in respect of homes for letting at social rents. Any further reduction simply makes a bad situation worse.

About CIH

The Chartered Institute of Housing (CIH) is the independent voice for housing and the home of professional standards. We have a diverse membership of people who work in both the public and private sectors, in 20 countries on five continents across the world. Further information is available at www.cih.org

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Annex – Extract from UK Housing Review: Contemporary issues chapter 3 Private finance for affordable housing investment: from debt to equity (Steve Partridge, Savills)

The last few years have seen a rapid growth in the deployment of equity investment into affordable housing in England. In contrast to the established sources of finance from debt or bond investors who provide funds for new development on a secured basis, equity investors provide and retain an equity stake in the new homes. Equity investment in affordable housing is potentially attractive to pension and insurance funds. This chapter explores the issues around the changing nature of private finance and the prospects for a significant boost to the sector in the form of equity investment. It aims to explain how different types and different sources of capital can be best used in delivering new affordable housing.

The needs of pension and insurance funds

There have been many attempts to define the basis and terms on which we might envisage investment at scale from pension and insurance funds in affordable housing. These have ranged from a focus on the stable, secure, low-risk, asset-backed nature of the investment, through to pension funds having some form of 'responsibility' to invest in affordable housing in their local areas. After all, for pension funds the fundamentals should all align: the funds exist for the long-term, so do the homes; the funds have millions of pensioners (some of whom might also want/need affordable homes) and therefore the money to invest; they are seeking inflation-hedged investments of a low-risk nature to match off against the inflation-linked liabilities in many defined-benefit pension schemes and, by investing in affordable housing, they would undoubtedly be contributing to the social good. It feels like we have been talking about levering in pension-fund investment for well over a decade. And we are still talking about it now: witness the recent push from government to get local authority pension funds to invest in 'levelling up' in their local areas.[i] Leaving aside the challenges associated with that initiative, is any progress being made?

There has been talk of a 'wall of money' waiting to find the right assets for long-term, low-risk investment. We hear more and more about environment, social and governance (ESG) investing[ii] – and how institutional investors worldwide are seeking this type of investment to prove their credentials in terms of social responsibility. One might be forgiven for thinking that we are still talking about it rather than doing it – and in many ways there is so much further still to go.

However, it is undoubtedly the case that investors have begun to make their moves, and there are several ways in which we can judge that equity investment from pension and insurance funds is rapidly becoming not only the 'next big thing' but possibly even the major basis through which future generations of new affordable homes will be financed. Moreover, despite initial scepticism from housing associations and local authorities, there are definite signs that the 'traditional' social housing sector is responding positively to the opportunities that this scale of funding potentially brings.

A brief history of housing association private finance

Until the mid-1980s, all social housing was supported by public or charitable funding. Delivery was almost exclusively through local authority direct provision of council housing. Many small housing associations (HAs) had also been created, in most cases to fill gaps unfilled by council housing (for example, specialist provision for specific groups of people).

Housing legislation during the 1980s introduced private finance at scale into the housing association sector for the first time, where HAs would borrow alongside capital grant provided by central government. Banks and building societies lent on favourable rates (relatively low margins) over long terms (typically 25 years) to HAs, building up the best part of £55 billion of investment in the period up to the global financial crisis (GFC) in 2008/09. The funding model fitted the operating model very well – net rental income covers debt costs over the long term, driven by indexed rent increases of at least RPI (now CPI).

The recapitalisation of high street banks post-GFC meant that access to cheap, long-term debt was restricted. In some cases, banks were 'underwater' (losing money) on much of their earlier lending and consequently wished to renegotiate loan portfolios with associations. As a consequence, HAs made much greater use of the capital markets for long-term funding. This has delivered around £25 billion of funding to date, commencing with the large players (Places for People, L&Q) but now extending right across the sector to relatively small associations. The bond issuances are well-suited to the high-demand, long-term inflation-linked and stable nature of affordable housing. There has been a full range of tenors (the length of time over which bonds are issued) ranging from ten years to 40+ years, with sizes starting as little as £50 million up to £350 million and even larger. The market has matured significantly and the rates of interest that are paid on bonds are now extremely competitive. There are three principal reasons for this: first, investors are looking for the strong ESG credentials of the HA , and will reduce their return needs to reflect ESG; second, the HA sector has a high degree of 'income stability' (i.e. it is low risk) and third, there is a huge weight of capital wanting to invest which also helps drive rates down.

This is all relevant as bond issues introduced new types of investors to HAs, including many UK and overseas institutions and pension funds. Many have become familiar and comfortable with the features, risks and rewards of the sector, and the strong regulatory backdrop which provides comforts for investors and others. The Regulator of Social Housing (RSH) has not seen any association ever in default and has, to date, always found a suitable purchaser or merger option for those small number of HAs that have got into trouble. The same applies to equivalent regulators across the UK.

The regulated status, as well as the steady income stream of general needs, affordable housing rents, have generated a huge amount of interest from investors, which continues to build momentum. Particularly during periods of economic uncertainty and volatility, capital has flowed consistently into associations as investors have sought quality and safety. There are plenty of examples in recent months that highlight this peak in demand, these include Clarion's £50 million 2048 bond in 2021 which priced at 0.88 per cent over gilts and LiveWest's benchmark primary issue of £250 million 2056s, which priced at 0.90 per cent over gilts and was substantially oversubscribed.

We have reached the point where private finance dominates the funding of affordable housing, being much more significant than grant. While the position is different outside England, Commentary Chapter 4 points to an RSH estimate that grant covers only six per cent of the capital costs of all new affordable housing, while a recent National Audit Office report assesses grant as covering just 24 per cent of costs for grant-assisted schemes, with 46 per cent covered by debt.

Wider financing options and equity funding

The solid track record of bond and debt funding has naturally led investors and fund managers to consider their options for deployment of wider pools of capital. While debt funding is a solid investment, it is not generally index-linked and so there is work to do for investors to create the right basis to match index-linked pension liabilities, by converting fixed streams of income received from debt lent to the sector, into index-linked payments to pensioners.

In the last decade, investors have therefore also begun to focus on equity funding, making direct investment in affordable housing and unlocking the potential for genuinely inflation-hedged investment at scale. Investors initially focused primarily on leased property in which the covenant strengths of local authorities and HAs were the key to low-cost funding. In this type of funding, the investor passes all the risk on (for example) rent collection to the lessee, so that even if there is no rent collected, the lease payment is still payable – in this case, the financial strength of the LA or HA keeps the cost of funds low. The first long-term reversionary-lease deals, where the investor has a right to possession at a future date, were undertaken with HAs in the early 2010s and a small number of such deals have also been struck with local authorities.

However, partly due to reticence on the part of HAs and local authorities (where straightforward debt represents a cheap, familiar and less complex source of funding), and partly also through poor understanding of the products on offer, the amount of capital deployed through leases in the mainstream affordable sector has so far been limited. The RSH has also had cause to make compliance interventions relating to lease structures – most notably with Cosmopolitan a decade ago but more recently, and continuing, with very small providers in the specialist supported housing sector.

Nonetheless, in response to the lack of demand from counterparties and reflecting what were until recently historically low gilt yields, lease terms have improved and are now becoming more balanced in risk-sharing – with the funds taking a greater risk share – leading to a wider diversification of offers being made on all sorts of different terms. These developments have produced results, with more lease deals being completed: most recently, for example, with the London Boroughs of Bromley and Barking & Dagenham.[iii] Yields remain competitive in the context of interest rates, gilts and other key global factors and despite recent adverse moves in the market.

The emergence of for-profit providers

The limited appetite for lease structures may have persuaded a number of investors and funds to set up their own for-profit registered provider (FPRP) structures and to directly own, fund and operate affordable housing – taking on the associated income and operating risks. And from 2018 onwards, FRPPs have emerged as the main engine for growth in equity investment.

Legal and General Affordable Homes, MAN Group's Habitare and M&G's RP exemplify the shift from being a lender to becoming an owner-operator. ReSi housing, Heylo and Sage Housing are all examples of leading new equity entrants now holding properties in FPRP entities. Other new equity entrants (such as CBRE IM) have not set up their own FPRP but work through lease structures with HA partners. There are currently 69 FPRPs registered with the RSH and a large number in the registration pipeline.

At the same time, bond issuances continue, and banks/building societies continue to lend actively to the HA sector. The availability of private investment across a range of these new, equity-related forms is however beginning to make a very significant contribution with an estimated £8 billion of equity in total now deployed over the last ten years, most of which occurred in the last 3-4 years.

The affordable housing sector has tended to use the catch-all phrase 'equity investment' to describe the new entrant capital that is available to deploy through leases and FPRPs. While this is a helpful term, it masks the wide range of types of equity and funds seeking looking to invest in affordable housing and how they differ from each other. As more funds deploy and leading early-mover FPFPs become more established, acquisitions and deal structures are evolving to produce a meaningful and plentiful supply of equity which is set to make a lasting impact on the sector.

What is in it for investors?

Even in a volatile economic world of higher inflation, higher interest rates and generally higher cost of capital, the relative status of 'affordable housing' as an investment class has not changed. These are the key motivators driving the appetite for this kind of investment:

- *Structural imbalance – persistent under-supply of homes – long-term government support.* Investors seek long-term investment models where there is a market imbalance to address over an extended period. Affordable housing is under-supplied, and the majority of income supporting its delivery (i.e. rents) is paid for from housing benefit or universal credit (i.e. the government). This is further emphasised by the underlying demographics – an ageing population, with new offers in older persons' housing, care and support, extra care, etc. being developed all the time.
- *Long-term, stable cash flows with indexation – provide an inflation hedge, leading to lower cost of capital.* Taken over a long timescale, liability matches to pension payouts; really secure, index-linked investments are rare in the market and affordable housing is one, therefore attracting the lowest costs of funds.
- *Exposure to residential real-estate market cycles through house-price inflation in shared ownership.* Another key factor is that the regulated affordable housing sector tends to come not only with long-term, secure rental income, but also increasingly offers shared ownership – which gives an even more secure RPI+ income stream from rents, with increasing comfort that staircasing proceeds can be reinvested quickly to maintain returns.
- *There is little correlation to other typical real-estate asset classes with rented tenures.* It is difficult to imagine anything less correlated than affordable housing compared to, say, retail and commercial investments. Relatively speaking, the housing sector will always be an attractive investment and changes brought on by the Covid pandemic may well have emphasised the volatility of investment in other asset classes.
- *Robust ESG credentials.* HAs have positive attitudes towards addressing climate change and sustainability, with many already developing their longer-term net zero strategies and targeting step-change increases in energy

efficiency. The social impact of affordable housing providers is beyond doubt. But the governance point is also critical – stable, independent boards of governance, clear accountability for delivery, backed by a strong regulatory framework. All the ESG factors are 'ticked'.

As none of these drivers are likely to change significantly soon, it is possible to say with some confidence that the appetite for equity investment in affordable housing will not diminish: quite the opposite, as more investment drives more returns, and more investors get interested and then get more comfortable with the sector. Appetite is likely to increase.

In fact, the ESG angle could be decisive in shaping investment behaviour going forward. We have already seen over 100 HAs sign-up to a voluntary *Sustainability Reporting Standard* on debt[iv] and it is almost certain that the new market norm will be ESG-compliance, meaning that those that are not reporting on ESG might face higher costs of funds. But we are also seeing investors flexing their ESG muscles to influence investees – witness the recent action from groups of investors to put pressure on oil companies to take their climate-change strategies seriously.

Regulated affordable housing in England is well-placed to take up this investment. In turn, these factors are likely to drive a wider range of types of deal and more diversity in the kind of partnerships that are developed between investors, FPRPs and the 'traditional' HA and LA sectors.

Some of the developments around partnerships are explored in more detail below. Given the prevailing economic and inflationary context, and pressures on the existing asset base through building safety and preparing for net zero, it is possible that equity investment will, over time, become the dominant source of capital for new affordable housing development. Certainly, that is Legal & General's assessment[v] – and whilst we are definitely still in the early stages, there are plentiful reasons for thinking that this is the general, long-term trend.

Prospects in Scotland, Wales and Northern Ireland

The focus of new entrant investment has to date been in England, with a small number of deals in Scotland. Previous proposals for Wales have not yet come to fruition. The concentration on England has been driven by the scale of need and demand, and therefore the scale of the addressable market and the opportunity to deploy significant amounts of capital. But another reason might be the availability of opportunities to vary the business model and therefore the basis for investment. For example, the legislation allowing 'for-profit' providers has not been replicated in Wales or Scotland and there no new RSLs have been registered in Scotland for more than ten years.

Therefore, the focus of the limited number of deals in Scotland has been on sub-market, affordable private renting, as opposed to investment in new forms of social housing. The promotion of 'mid-market' rents has been of particular interest to investors and the Scottish Government has generally been willing to support new forms of private capital, especially with the operation of guarantees. There is a history of supporting investment in the PRS via the Private Rented Sector Housing Guarantee and a recent consultation (Autumn 2022) on a Rental Income Guarantee Scheme.

In Wales, the government has tended to work closely with HAs and local authorities to lever in private finance via the existing landlord businesses, rather than to seek new approaches to lever in private finance directly. For Northern Ireland, the unique circumstances in which the Housing Executive operates as both a policy-directing, strategic body and as a landlord almost certainly makes the policy environment rather too complex and locally specific for investors to embrace readily. There may also be a question of scale of opportunity. This is not to say that investors are not interested, rather that it remains to be seen whether specific approaches in Scotland, Wales and Northern Ireland can bear fruit in bringing forward more affordable rented homes at scale.

Fund types

Whilst 'long income' and liability matching underpin investments in affordable housing, it is worth highlighting the different fund types and different investor types who seek different risk and return profiles – and this can also drive value for the sector. All types of fund are active in this market and some examples are given in the box.

Types of funds

- Long-income/ retirement and annuity funds – seeking long-dated, index-linked stabilised assets with as little interruption to returns as possible.
- Core/ Core plus funds – seeking investment over a medium term with the option kept open to hold for a long time or sell onto a long-income fund; this type of fund will be comfortable acquiring stabilised assets and in forward-funding new development (for example, section 106 acquisitions or development schemes).
- Value-add/ Opportunistic funds – as the name suggests, seeking additional returns over a generally short-to-medium-term period, seeking an exit by selling to a long-income or core fund; this type of fund will target forward-funding and new development, seeking higher returns from what is seen as a higher-risk investment.

Often the shorter the term, the more likely the fund will look to take on debt to help leverage the equity investment – in effect to make the equity work harder to drive increased returns. Investors can supplement equity funds by taking on additional debt – this gives the opportunity to acquire more properties for a given amount of equity. For value-add funds, we see leverage of up to 70 per cent, for long-income funds, it is equity only.

It is always the case that the higher the risk, the higher the required return. All types of capital seeking all levels of return have their place in this market and there is nothing inherently incompatible between value-add funds engaging in forward-funding of development at risk, then exiting to a long-income fund when everything is built, fully rented and hence stabilised. We will see this cycle play out in the next few years as these funds reach their set maturity dates.

But it is also critical to recognise that the ultimate investors (i.e. the sources of capital being invested into funds which are then invested in affordable housing and FPRPs) all tend to go back to pension funds and insurance funds. Pension-fund trustees would be expected to balance risk and return across their enormous portfolios – and that is precisely what we find: local authority pension funds, for example, will invest some money into value-add funds and some into long-income funds.

How do we expect to see the market grow?

Research undertaken by Savills in 2022 captured a 'point in time' in the evolution of the market and we will be followed-up in 2023. Here are some key findings.

Growth in FPRPs

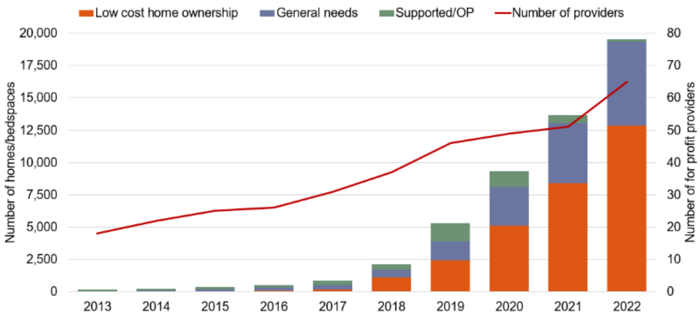
There were 69 FPRPs at the end of 2022, of four broad types:

- *Developer-led:* 29, including large multi-national, national/multi-regional, local-SME FPRPs, split between those set up early to allow acquisition of affordable homes on site and those set up recently for delivery of a specific pipeline of developments – all ranging in size but focused on specific areas for growth.
- *Local authority and existing HA-owned*: 4, but numbers could be set to grow as existing larger HAs may seek to rationalise stock balance sheets and raise capital in partnership with investors and funds.
- *Specialist*: 10, a range of specialist providers including some care/support and some lease-based for temporary accommodation and other specialist accommodation.

- *Investor led:* 26, in practice, this covers a wide range, including ones that have grown in the last 3-4 years (Resi, Heylo, Sage, Legal & General Affordable Homes – which make up just less than half this total as some of these investors have multiple FPRP entities) and those that have been established but are yet to achieve scale (for example, M&G SO, Man Group's Habitare, Octopus's Newmarch, HSPG's Park Properties); there is range of other funds with vehicles in place to take advantage of specific local opportunities (for example Williams Pears' MTD Housing, Matter Real Estate's shareholdings within St Arthur Homes and Auxesia Homes).

It is this small group of investor-led FPRPS that are driving real growth, in particular since 2018 (see Figure 1.3.1), with nearly 20,000 homes financed by about £8 billion of investment deployed or committed to date.

Figure 1.3.1 Growth of types of for-profit providers in England



Source: Savills research, 2022.

Looking ahead

Reviewing plans for investment, we can expect to see growth to continue apace, with what Savills considers might be as much as £27 billion invested in around 140,000 homes by 2027 (Table 1.3.1). Likely key developments include these:

- Shared-ownership supply is expected to average 21,000 homes per year. Of FPRP stock in 2017, 20 per cent was low-cost homeownership; it rose to 66 per cent in 2022, and is forecast to be 63 per cent in 2027 as the grant focus may well shift back to affordable renting.
- Large providers (more than 500 homes) own 91 per cent of the existing FPRP stock but those same providers will only own 76 per cent of stock in 2027 as newer FPRPs catch up.
- Three FPRPs with no completed stock as of 2022 have plans to exceed 1,000 homes in the next five years.

Table 1.3.1 Numbers and projected numbers of for-profit providers in England

	2017	2021	2022	2027		
				Current FPRPs	Additional FPRPs	Total

No. of FPRPs	31	51	64	64	c.25	c.90
No. of homes	873	13,671	19,600	111,400	c.30,000	c.141,000
Capital (£billion)	0.2	2.4	3.7	21.2	5.7	26.8

Source: Savills research, 2022.

Put another way, if new investors and FPRPs are accounting for upwards of 25,000 new homes a year by 2027, that could represent nearly half of all affordable homes delivery by that time, raising substantially the output of homes for shared ownership. There might even be reasons for believing that this is an underestimate given the growing pressures on the traditional HA and LA sectors.

What might interrupt this progress?

Investment is driven by policy and financial stability as well as the under-supply of affordable homes. There have been some strong headwinds influencing progress since early 2022:

- *Inflation and economic volatility*: the normal low-inflation environment has been interrupted and this affects affordable housing specifically in the delivery of services to residents and, ultimately for investors, also flows through into the costs of funds. Whilst the relative position is unchanged vis-à-vis other investments, equity returns across the board have risen.
- *Interest rates*: those funds reliant on some measure of debt to make their investments work are likely to find themselves less competitive than they were until rates began to rise last year, which in turn is likely to have interrupted progress until debt terms can be realigned.
- *Policy instability*: changes in the Affordable Homes Programme 2021 caused some uncertainties (for example, shared ownership schemes covering repairs costs for the first ten years, rent-to-shared-ownership options, minimum staircasing of one per cent). Investors will always point to a need to set quality standards and stick to them, but uncertainty has been caused by the cap on rent increases of seven per cent in England, together with the NHF-led voluntary cap on shared ownership rent increases, leading to below-inflation increases in income. Whilst seven per cent will be challenging for many social housing residents, net income does decrease in real terms, with the prospect of continued high inflation into the autumn of 2023 potentially affecting rent increases for 2024 as well.

Funders and investors would like to see government and the regulator provide stability in rents policy, set out over the long term, so that investors and fund managers can plan over a timescale, take a view on current levels of volatility and thereby keep the cost of capital as low as possible.

Not separate sectors: what partnership offers

The FPRP sector is often seen as something completely distinct and separate from the 'traditional' not-for-profit sector. In many ways, the early days of new entrant investment may well have caught some HAs by surprise as a new source of competition came into the market. Certainly, the sector tended towards expressions of degrees of scepticism, particularly around what might have been perceptions of the motivations of investors, and whether affordable housing could meet what were (at that time and misleadingly) seen as higher return requirements.

As this chapter argues, however, times have changed, and whilst learning is still going on, there are very good reasons to expect that the social sector will embrace new forms of partnership with equity investors in the next few years. Some of the drivers have already been discussed: pressure on HA finances combined with a need to focus on the existing stock, the sheer volume of capital seeking deployment, the strong ESG characteristics of the sector. This latter is critical – every single one of the main movers from the investor community have partnered with traditional HAs for housing and property management – initially for management agreements but all part of the 'getting to know each other' dynamic.

For housing associations, equity investment offers the following:

- *Access to investment capital*: whilst lending from banks/building societies and bond issues will continue, the huge volume of capital available for equity investment is a key potential future source for HAs, who are in a good position to make a strong offer to investors (for example on ESG, and their ability to provide quality services).
- *Continue to grow operational platform*: by accessing capital from new sources, HAs may not necessarily be the owners of new build properties, but they will be able to utilise their established approaches to service delivery to continue to grow their service platform (i.e. the delivery of management and repairs services).
- *Maintain development expertise and output*: again, by accessing capital from new sources, HAs will be able to maintain and potentially grow their development teams to manage and deliver new developments, albeit financed by investors.
- *Cross-pollination of knowledge from other sectors, and other sources of investment*: as HAs and LAs learn more about investors and the new types of finding, so investors find out more about operating social and affordable housing, leading to greater opportunities for partnership.

- *Financial market-tested risk and governance processes that have been applied to social housing for decades*: the importance of the regulatory and track record of HAs in utilising private finance for 40+ years cannot be under-estimated – not one £ of funding ever in default and a strong record of independent and quality governance at board level.

- *Potential access to new opportunities from FPRPs active across multiple living sectors*: some HAs have diversified into delivering other tenure types, including for example market renting and student accommodation; many investors also have these additional 'living' platforms.

For equity investors, housing associations and the existing sector offer the following:

- *Rapid access to properties to accelerate deployment and growth*: one of the key targets for investors and fund managers is scale, i.e. actual deployment of capital; working in partnership with HAs can offer such scale.

- *Access to experienced developers and operators of social housing*: the established track record of the HA sector in delivering developments, and in managing and maintaining properties once built, are key strengths as investors can work with established providers rather than set up their own platforms from scratch.

- *Involvement of non-profit HAs (or LAs) adds credibility to development schemes*: most investors and fund managers are extremely concerned about reputation, particularly as they are investing pension fund monies on behalf of millions of ordinary people; the involvement of HAs and LAs is definitely a reputation-enhancer for investors. Additionally, as noted above, there is a really strong ESG angle to working with HAs and LAs.

Types of partnership

What types of partnerships are emerging? Here are six examples which give a flavour of how the market is evolving and how the non-profit and for-profit sectors are beginning to collaborate. Some are well established, some are just getting going, but all are likely to play their part going forward:

- *Long leases:* In many ways, this is where equity investors came in, and where long-income investment feels most comfortable, drawing upon the covenant strength of a larger HA or local authority; the model accesses freehold or long-leasehold properties, investors lease to the LA/HA over a long period, index-linked generally at CPI (although returns are even lower for CPI+ leases), with a reversion to the LA/HA for £1 at the end of the lease – a type of index-linked finance. This may well continue to be a small minority of completed deals, but they are likely to have a place, perhaps for local authorities with their wider placemaking roles, where authorities gradually get more comfortable with index-linked funding.

- *Sale of HA pipeline to a FPRP/investor:* An HA allocates and sells some of its development pipeline to an investor, maintains the development management role to deliver the new homes, and then manages the properties when built. The investor finances the developments (what is known as 'forward funding' i.e funding in advance of the properties becoming income-producing), creating more headroom for the HA to invest in other elements of their business plan. There are several examples of such deals, most recently Legal & General with Metropolitan Thames Valley.[vi]

- *Sale of HA development pipeline into a joint venture with FPRP or investor:* An HA allocates and sells some its development pipeline into a joint venture (JV) with an investor with a FPRP, with different models of JV structure but essentially all focused on joint ownership of the provider that owns the stock when built. The development management role and future management and maintenance roles are retained by the HA.

  The key example here is AXA and Hyde entering into a jointly owned 50:50 FPRP called Halesworth Housing.[vii] Whilst there is just this one currently, it might be expected that FPRPs jointly owned by HAs and investors will become more commonly used, as HAs are then able to influence the direction of growth of the FPRP. Whilst Halesworth is a 50:50 arrangement, many investors are likely to want to seek majority control of a JV organisation, particularly as the mandates (i.e. what they are allowed to invest into and what they are not) might stipulate that the fund/investor has control over the future of the JV organisation.

  Examples of a full range of JV structures are likely to emerge soon, and all would represent additional capital invested in affordable housing. In no sense is this a 'takeover' of traditional HAs by new investors, rather both sides working together to find new ways to achieve each other's objectives.

- *Sale of stabilised assets into a FPRP/Joint Venture structure:* An HA sells a portfolio of established income-producing stock to a FPRP/investor, raising capital for reinvestment into other priorities and continuing to manage the stock. To date, the focus has typically been on shared-ownership properties as they are seen as particularly low-risk by investors, and the post-sale management arrangements remain relatively straightforward as costs are low and do not cover repairs. Whilst Hyde are also the key exemplar for this approach, with M&G the investor, it might be expected that more of the larger shared-ownership stockholders will consider similar options. There are upwards of 300,000 shared-ownership properties within the HA and

FPRP sectors currently: tens of £billions of value that could potentially be released from HA balance sheets for reinvestment.

- *Investment into new development via a framework:* Not all partnerships need to be focused on new structures: there are examples of investors and funds simply financing development pipelines through a framework or other form of 'right of first refusal' (ROFR) agreement. This could be partnerships between investors and existing 'traditional' HAs or for newly created FPRPs seeking to grow, particularly those led by developers where there is a pipeline of sites and the opportunity to provide affordable housing supply, but where the developer is seeking new sources of funding to ensure the developments can go ahead.

  A small number of such partnerships are at an early stage of development (in early 2023), with the potential for this arrangement to grow. The key benefit for the FPRP/developer is to secure funding, the benefit to the investor is to deploy capital, but the 'ROFR' approach does not tie the parties into a fixed JV structure, thereby leaving more flexibility for the parties to seek funding or investment elsewhere as appropriate.

- *Management agreements for new FPRP stock:* This is by far the most common approach to partnership working to date. FPRPs and investors seek partnerships with established HAs to bring their expertise to help deliver against the regulator's standards and to offer experience and a track record as the FPRP grows. Sage and Heylo use one HA, Legal & General Affordable Homes use a panel of 13 HAs. Management agreements are not generally long, usually for no more than ten years and frequently shorter; generally, there is a split of risks and rewards between the parties – for example on arrears, void periods, lettings and repair costs. This type of shorter-term arrangement works especially well for newly created FPRPs where there is not (yet) the capacity to manage and maintain properties. They can draw on the expertise and track record of the HA sector, which offers reputational advantage in the context of the RSH (i.e. an investor partners with an existing HA to add to their social investment credentials).

  It works well for a HA to grow their management services at a time when they may be constrained in financing new developments and section 106 acquisitions. It is, put simply, an ideal way to 'get to know each other' and examples like this can be expected to grow and diversify in the next few years as the appetite for further collaboration grows.

Conclusions

There is massive interest from investors worldwide in affordable housing in the UK, and specifically in England. There is also a growing interest from housing associations for alternative funding solutions to support investment and growth.

There is a mix of activity and a range of models and there is an emerging market for all types of partnerships. The key market drivers are clear, and despite the challenges of inflation, interest rates and general economic volatility, they are unlikely to fundamentally change:

- New equity investors focus on the acquisition of section 106 schemes and grant-funded development schemes – with the likes of Legal & General Affordable Homes and Sage having led the way.
- New equity investors finance housing association development pipelines as HAs 'retrench' into asset management on their existing stock (dealing with fire and building safety, net zero and energy efficiency).
- New equity investors acquire stabilised housing association assets with management maintained by the HA, releasing capital for HA reinvestment – there is a large pool of buyers with FPRPs capable of acquiring at scale.

Just as occurred with the introduction of private finance in the 1980s, leading to a rapid growth in debt funding over a sustained 25-year period, the new age of equity investment has arrived and has really begun to 'kick in' from the late 2010s/early 2020s onwards. Far from seeing the growth of equity investment as somehow a separate sector, it is far more likely that such investors and the established sector will become important partners in addressing the supply and delivery of affordable housing, for decades to come.

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[i] See www.lgcplus.com/investment/gove-announces-plan-for-16bn-lgps-levelling-up-investment-31-01-2022/

[ii] For a brief explanation of ESG see www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp

[iii] For details of the schemes, see www.pensioncorporation.com/news-insights/press-releases/2021/pic-invests-p67-million-in-innovative-bromley-affordable-housing; www.railpen.com/news/2022/trocoll-house/

[iv] See https://sustainabilityforhousing.org.uk/

[v] See Legal & General and BPF (2022) *Delivering a step change in affordable housing supply*. London: Legal & General.

[vi] See www.mtvh.co.uk/news/mtvh-and-lg-affordable-homes-form-joint-venture-partnership-to-deliver-2500-new-affordable-homes/

[vii] See www.socialhousing.co.uk/news/hyde-set-to-hatch-more-for-profit-rps-79270