Chartered Institute of Housing

savills

CHARTERED INSTITUTE OF HOUSING: SOCIAL RENTS ANALYSIS

1. Introduction

This commentary and analysis was instructed by the Chartered Institute of Housing (CIH) during August 2022 in response to the likely high rate of CPI inflation at September 2002, which would, without any intervention from housing providers, government or the Regulator of Social Housing, result in very large increases in social rents at April 2023.

There is a strong feeling within the CIH and its membership, and the wider affordable housing sector, that rent increases at CPI+1% (expected to be in the region of 11%) would be unsustainable for tenants and residents, particularly in the light of the prevailing cost of living crisis which has seen essential goods and services, particularly food and energy, subject to significant inflationary pressures in the recent years, and which is likely to continue.

In the run up to August, therefore, there was a prevailing view that members of local housing authorities and boards of private providers would generally be unlikely to want to increase rents at CPI+1%.

This is however in the context that expenditure pressures exerted on providers have been well above the prospective level of rent increase, continue to be so and this situation is likely to carry on into the near-term future.

The result of expenditure pressures being greater than prospective rent increases will lead to revenue losses for providers. The potential level, range and extent of these are explored in this paper.

The original instruction sought to test the implications of providers exercising restraint in increasing rents – effectively voluntarily capping increases. Subsequent to the instruction, the Government is formally consulting on a nationally applied cap on rents at a range of levels; therefore, the work to inform this paper will now form part of the response by CIH to the DLUHC consultation document, due by 12th October.

The economic and policy environment remains extremely fluid, following the appointment of a new government including new DLUHC ministers, and in respect of related policy initiatives that might have a significant impact on the work undertaken.

At the time of writing, the measures announced within the “mini-budget” on 23rd September could have a material impact on the assumptions made within the analysis summarised below, especially in respect of both their impact on 1) mitigating the impact of inflation towards certain key expenditure items (such as energy and utility costs to 2023/24), but also 2) and potentially more significantly, the overall level of CPI itself.

2. Areas of enquiry

The specific areas addressed within this paper are set out below:

1. An estimate of inflation assumptions built into current housing providers business plans
2. An assessment of key determinants of landlord costs and of likely inflation in them over the years 2022/23 and 2023/24, in comparison with CPI inflation
3. An assessment of the level of the percentage rent increase required in April 2023 to meet expected costs, meet business plan requirements, including an assessment of the range of such forecasts

4. Commentary on outliers (i.e. landlords with significantly greater cost pressures, landlords without new build programmes, landlords in the care business).
5. Commentary on implications for the longer-term rent settlement (e.g. convergence)
6. Commentary on other government policy issues that might affect the assessment (e.g. Right to Buy)
7. Consider any options for restraining rent increases that the sector might offer (or government might propose), and their implications (this part to remain confidential)
8. Considerations relating to service charges and service charge increases
9. Feedback as to how members and boards are viewing rent increases in the light of cost of living pressures on tenants.

3. Methodology

We have drawn evidence from a wide base of providers, within the local authority and RP sectors, and have cross-referenced this with other pieces of work undertaken for trade bodies, particularly in the local authority sector.

We have prepared an analysis of the "national position" relating to local authorities and private RPs utilising core data drawn from, in the former case, Savills' own 5 year analysis of all HRA final accounts statements, and in the latter, the Global Accounts produced by the Regulator of Social Housing.

We have applied a range of scenarios in respect of rent and income inflation consistent with the policy options under consideration by government and by providers themselves.

We have also applied a range of expenditure inflationary assumptions based on the collation of a range of evidence bases as follows:

- Feedback from providers via CIH and directly to Savills, including all types of client providers (local authorities and RPs) on their experiences of inflation in key cost areas
- National forecast indices relevant to each area of expenditure (e.g. BCIS for construction costs, pay award offers for local authority employee costs)
- Cost of capital (i.e. interest rate forecasts) drawn from Savills Financial Consultants and the experience of providers directly.

We have engaged directly with providers in relation to "specialist " areas such as supported housing and extra-care.

We have also gathered feedback from providers in relation to the perceived intentions of their boards and members, so as to capture a sense of the "mood of the sector".

We have also undertaken an analysis of the possible risks of tenants failing into arrears as a result of cost of living pressures elsewhere within their household budgets, which we hope is of interest to CIH and its members in the context of direct impact on housing management.

The situation remains fluid in the context of ongoing announcements, and it is likely that some of the analysis set out below may need to be refined in the light of further work undertaken to understand the implications of the government key fiscal announcement on 23 September.

All references to business plans reflect business plans in place prior to the current discussion on rent increases.

4. Business plan inflation assumptions for rents and income

4.1 Rent increase assumptions

There are essentially two approaches adopted by all providers in setting out the longer term trajectory of rent increases over the long-term. With rare exceptions, all providers have modelled CPI+1% up to and including 2024/25.

Beyond 2025, the key approaches can be summarised as:

- CPI+1% - a majority of providers, virtually all private RPs and a large minority of local authorities; the assumptions made by RPs are consistent with both the approaches expected within business plans in relation to agreements with lenders, and with the approach to security valuations provided by the main valuation agencies.
- CPI – we find a very small handful of RPs with longer term rent increases at or below CPI, primarily small specialist RPs not reliant on bank funding.
- We find a majority of local authorities have adopted an approach to CPI only from 2025.

The levels of rent increases within business plans are generally predicated on the long-term forecast for CPI from the OBR at 2%, therefore 3% pa for RPs (occasionally 2.5% CPI and therefore rent increases of 3.5%) and some LAs, and 2% pa for most LAs.

Critically, we find that the recent spikes in inflation have come at such a pace that very few, if any, providers have amended the assumed underlying rate of CPI from 2% (occasionally 2.5%) even in the very short-term within their business plans.

In summary therefore, the overwhelming majority of providers are (or have been) projecting a rent increase of 2% or 3% within their business plans for April 2023 and April 2024.

4.2 Rent convergence

It is highlighted that a significant number of providers (particularly local authorities) have not “converged” rents with target or formula rents – our estimate is c80% of HRA authorities are “below target”.

The principal reason for this is the interruption to rent convergence during the period from 2005 to 2012 and then its cessation by government from 2016. Many authorities have felt that this cessation adversely affected their ability to finance expenditure and “locked in” what was a work-in-progress position at 2015 which successive governments had encouraged.

In some cases, the distance from convergence is significant, particularly as a result of frozen or below CPI+1% rents increases since 2020. For example, around 30% of authorities are not thought to have increased their rents CPI+1% in April 2022[1], although in most of these cases, rents were still increased.

---

[1] *Inside Housing and Savills own HRA user group research*

That rents might not be at target or full formula rent levels is also found to be a similar issue for some RPs, particularly those that may have a significant amount of former local authority stock[2].

We have tested whether providers incorporate within their business plans an increase in future rent income that is above CPI+1% as a result of a general policy to relet at target rents. We find that whilst most authorities do relet at target, no authority with which we have engaged makes an assumption of the rate of relet, presumably electing to take the marginal gain into the business plan upon update rather than as a matter of projection.

Feedback from providers has also highlighted that whilst convergence is not an issue in respect of Affordable Rents, as these tend to be quite a bit higher than social rents, there may be a case in local circumstances for differential increases applying to different tenure types.

Impact on business plans

When considering the projected level of CPI for September 2022 (to drive rent increases at April 2023), all providers have recognised that the level of CPI+1% would be in the region of 10-11% (depending on the precise timing of the projection).

Whilst there has been a very small number of providers (all private RPs) that have stated publically the need to stick to CPI+1% and implying that rent increase at this level were under consideration by their boards, in practice we find that the overwhelming majority of providers would not have seriously considered increases at this level.

We understand that many have recognised that a rent increase at 5% or 7% would be above the level of rent increase that was included within their business plan.

Put simply, rent increases at this rate, whether capped by government or levied voluntarily, would deliver more cash into business plans for 2023/24 and all subsequent years.

Whilst providers have recognised that business plans would therefore have more cash income, whether the increase would be at 5% or 7%, there is also deep concern that expenditure inflation as it affects providers' key expenditure areas is actually running at or above CPI (see below).

DLUHC Impact Assessment

We note that the Impact Assessment which accompanied the government's consultation paper set out the rent increases "losses" below the projected level of CPI+1%.

DLUHC have based the assessment on the difference in Present Values between rent income received at the full CPI+1% rate (10-11%[3] in 2023 and 2024) and rent income following the proposed capped levels, suggesting this would be the impact on the sector of a cap.

This might appear somewhat disingenuous in this context, as it is in the interplay between income and expenditure increases that affect the future financial viability of the business plan.

We have based our assessment of future net revenues utilising forecast inflation for expenditure and how this is affected by proposed rent caps. As set out above, the difference between CPI+1% (at 11% for example) and a 5% cap is not necessarily considered by

[2] *One medium sized HA quoted an income gap of £20m*

[3] *DLUHC Impact assessment measured CPI September 2022 at 9.6% and September 2023 at 9.5%*

providers to be a "loss of income" of 6%. It is however important to compare this increase with the drivers for cost inflation for 2023 onwards as this will form the basis of an impact assessment more reflective of the actual impact on business plans. Such an approach also enables us to capture the impact of cost inflationary pressures which exceed CPI in the current and future climate.

5. Assessment of key determinants of landlord costs and of likely inflation in them, in comparison with CPI inflation business plan inflation assumptions for rents

We have worked with a range of providers to determine the drivers of cost inflation applying to the delivery of housing landlord services.

For ease of illustration, the split of expenditure inflation drivers has been applied as follows.

5.1 Housing management and services

The primary cost driver relates to pay and salaries. Our estimate is around two thirds of housing management costs are driven by employee costs. In the RP context, this also applies to central and corporate costs, and in the LA context, recharges to the HRA from central and corporate functions.

The remaining costs of housing management fall into the general categories of external contractors, supplies and materials, and utility/energy costs, and whilst the proportion of each varies depending on circumstance, location and service delivery model, around one third of each type applies to non-employee budgets.

5.2 Repairs & maintenance

The primary cost driver affecting repairs expenditure is external contractor costs.

A significant minority of RPs and majority of LAs employ direct labour in some form or other, with some carrying very large DLOs. Our estimate of employee cost drivers informing pay awards for DLOs and other direct repairs employees (client and technical/managerial staff) is around one quarter of costs. Clearly, for a large LA with large DLO (for example), the employee cost element will be much greater (perhaps up to two thirds).

For a repairs service that is entirely outsourced, the employee driver is likely to be c10% or less. Overall therefore 25% appears to be reasonable view of the sector average.

We estimate that around one quarter of costs of repairs relate to materials.

5.3 Major repairs and construction

Whilst there is occasional use of in-house staff on major works and construction/development programmes, the overwhelming majority of work is outsourced to contractors. Whilst some element of "capital management" is charged to programmes, particularly development programme, and inflation here may be driven by pay awards, we find the pay ranges of programme managers tend to be in line with wider inflation in the construction market.

For ease of illustration, we have therefore assumed that all major repairs – whether charged to Income and Expenditure in RPs or the Major Repairs Reserve for LAs – and all development costs are driven by the wider inflation in the construction market.

5.4 Employee costs

Pay award offers have been announced for those local authority employees affected by national pay structures. As it is a flat rate offer, if implemented it may affect different authorities in different proportions with authorities with relatively lower paid staff experiencing a higher percentage increase. We find the range anything between 5% to over 8% depending on pay structures and the volume of lower paid staff.

For RPs, as pay award negotiations are more localised, we find a wider variety of experiences, though we are not aware of any provider that is offering anywhere near the level of CPI – with the majority also falling into the 5-8% range, with a significant minority below 5%.

5.5 Contractors and suppliers

Experience varies widely in terms of indexation rates and new contract tender prices but we are aware of a number of key trends across the sector:

- The shortage of tenderers for many repairs and construction contracts, driven by a shortage of labour, both skilled and unskilled trades
- A tendency for successful tenderers to wish to renegotiate prices before commencing contracts
- A number of contractors going out of business during the course of contracts.

These, and other factors, provide for a very unstable environment, especially in relation to contracts that are being relet or being let for the first time.

For ongoing contracts, the principal indexation relates to BCIS-construction, BCIS-labour or BCIS-maintenance drivers. Whilst many new contracts may exhibit price inflation well above CPI, the overall experience is felt to be at or around the level of CPI.

5.6 Materials

Similarly, materials and supplies are affected by shortages earlier within the supply chain, with providers' opinions that these are driven by a combination of factors, especially: supply chains yet to fully recover post-Covid, the departure from the EU and the current geopolitical situation.

In some cases, this is leading to interruptions in supply, in others significant inflationary drivers, although it is felt appropriate to interpret that these drivers to be at a minimum of the level of CPI (being 10%) when taken across all expenditure areas across the sector as a whole.

The experiences in some parts of the overall supply chain may be very challenging, overall inflation c10% (as a minimum for modelling purposes) appears appropriate.

5.7 Utility/energy costs

For energy costs, the experiences are however significantly exacerbated.

Many providers lock into supplier contracts for a period of years.

Where these are coming to an end, and where contract prices are being re-quoted we are aware of some extremely large movements in prospective costs.

As a minimum we have not come across any provider that has had quoted an increase at less than 50% on current costs (and this is on the basis of contracts that were entered into relatively recently).

At the higher end, we are aware of contract quotations at increases of over 400% (i.e. five-fold increase)[4].

There is likely to be some general negotiation down around proposed prices, but our estimate of 30% increases in 2022/23 and 100% increases in 2023/24 are based on the very lowest end of expectations.

5.8 Summary

We have presented for reference two separate approaches to estimates of expenditure drivers at annex 1.

The first of these draws upon a blend of indices data (which vary monthly) and experience of feedback from RPs and LAs, set as an average across both sectors; we might usefully state that we would expect these to be a minimum for modelling purposes.

The second of these are up to date assumptions being utilised to inform security valuations for RP stock in charge to lenders.

It will be noted that the assumptions are very similar, with a slightly higher rounded and blended series of drivers drawing upon local business plan assumptions (as opposed to reliance solely on indices).

One area of continued uncertainty relates to the level of CPI forecast for September 2023 in the light of the various government announcements relating to energy and other cost capping. Assumptions of CPI within business plans of providers tend therefore to be above the very latest Treasury forecasts (as set out in annex 1).

The consolidated estimate of inflation drivers for expenditure across both sectors, taking into account the variation in pay awards assumed, are therefore as follows:

	2022.23	2023.24	2024.25
Consolidated repairs inflation	7.40%	9.20%	6.40%
Consolidated management inflation	5.25%	16.40%	9.35%
Construction costs	7.00%	10.00%	7.00%

** All costs assumed to revert to CPI+% 3.5% pa increases from 2025 (aligned with rent increases)*

6. Assessment of the level of the percentage rent increase required in April 2023 to meet expected costs, meet business plan requirements

Our impact assessment is set out in summary below, based on the above assumptions. To clarify, this assessment is based on our best calculations of likely actual changes in landlord costs due to projected inflation, as against the DLUHC Impact Assessment, which is based on a change in presumed rent income comparted to increases of CPI+1%.

[4] *In one case we are aware of a 25,000 unit RP in the North where annual costs of £4million have been quoted to increase to £18million.*

6.1 Projected net resources challenge 2023/24

The overall assessment of net impact on business plans for increases in expenditure as set out above and increases in income (principally rents) at the rates set out in the consultation is set out below.

As against the DLUHC assessment (for the sector as a whole) of a projected annual and 5 year impacts, our best assessment of the impact of each proposed level of cap is set out below, identified separately for each of the RP and LA sectors.

At a cap of 5% for 2023/24:

- LAs projected net loss of resources £400-500million – equating to between c5-7% of all operating costs (management, maintenance and major repairs) and c7-9% of operating expenditure excluding major repairs.
- RPs projected net loss of resources £750million-£1billion – equating to c7% operating expenditure or loss of interest cover of up to 15-20bps.

At a cap of 3% for 2023/24:

- LAs projected net loss of resources £600-700million – equating to between c7-9% of all operating costs (management, maintenance and major repairs) and over 10% of operating expenditure excluding major repairs.
- RPs projected net loss of resources £1-1.2billion – equating to c9% operating expenditure or loss of interest cover of up to 30bps.

At a cap of 7% for 2023/24:

- LAs projected net loss of resources 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.
- RPs projected net loss of resources up to £400million – equating to c3-5% operating expenditure or loss of interest cover of up to 5-10bps.

6.2 Impact of financial market movements

Movements in lending markets, base rates and gilt yields since the 23rd September announcement have led to volatility and unpredictability around the costs of finance to be assumed going forward[5].

However, work undertaken by Savills colleagues has highlighted that long-dated lending at rates being quoted on 3rd October suggested that this might take a further average 20bps off interest cover across the private RP sector.

Whilst just over 80% of the borrowing in the RP sector is at fixed interest rates (i.e. hedged against increasing interest rates in the short-medium term), rising interest costs will significantly reduce financial capacity, as well as lead to more short-medium risk as RPs turn to shorter-term loans with associated refinancing risks.

---

[5] For example, PWLB rates for 50 year maturity loans increased to c5.7% on 28th September but have since fallen to c4.2% on 3rd October bur risen again to c4.7% on 5th October

Early indications from the credit ratings agencies suggest that many associations could be subject to ratings downgrades, with the entire housing association sector at risk of potential downgrade.

This average will likely mask a large degree of pressures within those associations that have lower than average operating margins, higher than average liabilities towards stock investment, and in some cases, the implications will be to potentially breach covenants.

Taking the net impact of a rent cap at 5% combined with increased financing costs, our estimate is that around 30% of all RPs may trigger "golden rule" reviews of their lending covenants and business plans.

In these cases, a combined programme of revenue savings and cutting back on capital investment is likely.

6.3 Responses to prospective losses

We find a significant difference of emphasis between local authorities and RPs in regard to the approach to addressing projected net income shortfalls.

In general, many local authorities with HRAs have operating margins which are able (or have been able) to sustain capital investment borrowing for new development, for acquisitions and latterly for building and fire safety works (in some cases at scale).

However, there are two key differences compared to RPs:

- The general level of operating margin is below that of RPs (22% including major repairs in 2020/21)
- Surplus resources are as likely to be utilised as additional revenue contributions to capital programmes or even debt repayment, than to sustain additional borrowing.

In turn, this is likely to mean that reductions in net income are balanced through reductions in revenue expenditure (i.e. cuts in services).

Whilst LA reserves are in the region of £3.5-4billion, we have not picked up a trend towards thinking that one years' reduced rent increase would be addressed through drawing on reserves to any great degree, although in some cases this is likely to be part of the solution. Authorities are far more likely to hold onto reserves against future uncertainty beyond 2024.

For RPs however, the reduction in net income is likely to be initially measured as a fall in interest cover and options for rebuilding interest cover, recovering flexibility and resilience within the business plan taken as a rounded set of decisions affecting operating expenditure, investment in the stock and scaling back new build programmes.

Those RPs committed to Strategic Partnership programmes with Homes England are likely to feel pressure from three directions: construction cost inflation, challenges in programme delivery timescales given labour and supply chain shortages or contractor liquidations, and increasing borrowing costs.

These are prevailing issues irrespective of any cap on rent increase but will need to be addressed in the light of net reductions in operating margins.

6.4 Examples from research

Previous research undertaken by CIH during the course of the summer (and pre-dating the government's consultation) highlighted some examples of potential impacts:

Large private RP experience

- Rent cap and inflationary pressures are in context of significant additional investment in Building Safety (in this case more than £30m over the last two years, with a plan to spend at least £100m over five years) which was already pushing borrowing capacity to build additional affordable homes under SP programmes
- Rising costs associated with service delivery are exacerbated where there is a skills shortage, including technology/digital transformation roles, development and building safety roles
- Many providers face significant increases in pension costs, including employer funded past service deficit payments running to several £millions each year
- Responses to the need for more investment and to address these pressures have been to continuously review the cost base meaning that there is now "less to go at" than previously in terms of further efficiencies, without significantly adversely impacting services and homes

Medium-sized RP experience

- At 5% capped increase, and no change to energy efficiency and initial net zero carbon programmes leads to breach of interest cover (EBITDA-MRI) covenant by 2027/28; the RP operates a higher "golden rule" of 1.38 and therefore required to increase operating margins through reducing expenditure to cover at a rate above that level to allow for future additional stresses arising.
- Already have a Hardship Fund for tenants struggling to pay their rent. Consideration would be required to increase from £40k to £150k even with increases at 5%.

6.5 Summary

The "minimum rent increase required to stand-still" as stated by LAs and RPs engaged as part of this research effectively fall into the range of 7-9%.

Our research and analysis into the numbers suggests that these might be understated.

The combined impact of lower rent increases compared to increases in revenue and capital expenditure, and increasing financing costs, is likely to lead to significant challenges for many privately financed RPs in restoring resilience and flexibility to their business plans.

For local authorities, the choices are more likely to be focused on expenditure reductions, with particular challenges around investment into the existing stock.

7. Commentary on outliers (i.e. landlords with significantly greater cost pressures, landlords without new build programmes, landlords in the care business, etc)

7.1 Developing RPs

For RPs with large development programmes, the combined impact of net reductions in operating margin from the interplay between capped rent increases and higher inflation on costs together with increased borrowing costs is likely to lead them to reconsider the scale of programmes, certainly beyond the current Strategic Partnership programme period.

It should be noted that increased interest rates on borrowing are also likely to profoundly impact equity investment from new For Profit RPs; these bodies might otherwise have been able to take up some financing to maintain development and s106 acquisition programmes.

The impact of capped rent increases would therefore likely impact activities on those RPs with the greatest range of programmes. Those with lower reliance in new build programmes may be more likely to focus on their revenue and reserves position.

7.2 Fire and building safety, energy efficiency

Significant capital investment programmes financed directly from operating income or financed via borrowing are being focused towards the existing stock under these headings.

Our estimate[6] of an overall average of £7,500 per unit additional costs for the existing stock (over and above usual life cycle replacements in the forthcoming period) suggests c£12billion for LAs and c£18billion for RPs is already placing significant additional pressure within business plans.

The implications on private RPs have already been felt as many have negotiated carve outs for building safety costs for their interest cover covenants, and many lenders and RPs have agreed to focus on EBITDA[7] interest cover as opposed to EBITDA-MRI[8] interest cover.

The net reduction in interest cover across the board will be felt across both covenant approaches and lead to significant pressure in working through the implications of capital investment into the stock.

Given that many of these programmes are deemed essential in order to comply with legislation, and are also subject to 10% inflationary pressures, this is likely to focus the recovery of operating margins within RPs towards savings in day to day management and service costs.

[6] Savills research into fire, building safety and energy efficiency costs (to EPC C)

[7] EBITDA = Earnings before Interest, Taxation, Depreciation and Amortisation – the Net Operating Income arising from operational income and expenditure, commonly also referred to as Operating Margin

[8] Interest cover is a standard lender covenant comparing net operating income to interest costs measuring the headroom to cover costs should operating conditions change; in the last 10 years, lenders have focused on interest cover taking into account “Major Repairs Included – MRI” and setting on average c1.10 as a minimum hard covenant and 1.25 as a “Golden Rule” which triggers lender review; recent trends have been to carve out some major repairs from this calculation so that covenants are not breached; very recently many lenders have been prepared to revert to excluding major repairs from the calculation entirely, setting it higher (generally 1.75).

For LAs, it is not an overstatement to say that given the pressures on HRAs arising from net reductions in income (as above), if these essential programmes are to be completed, there is likely to be a need for direct capital grant support to complete the programmes.

7.3 Supported housing providers

Long-term measurements of operating margins applying within RPs differ significantly between general needs housing and supported housing.

Supported housing income and expenditure is rarely reported separately within HRAs hence evidence is local and anecdotal.

Margins for RPs are better measured and understood: general needs margins are approaching double those of supported housing and other activities.

Supported housing margins can vary between 10-20% and therefore pressure on net operating budgets significant from capped rent increases.

Conversely, the overwhelming majority of supported housing users are likely to be in receipt of benefit to cover rent and service charge costs. It is likely that the provision of these services would come under significant financial pressure if rents are capped below CPI+1%.

8. Commentary on implications for the longer-term rent settlement (e.g. convergence)

Our modelling has tested a range of scenarios which set out future rent increase trajectories beyond 2024.

8.1 Rent increase 2024/25

Until recently many commentators have tended towards a projection of CPI which falls sharply back to the long-term 2% OBR target but over a period of 2 years. This has informed our assumption of 6% for September 2023 (see above).

In the last 2-3 months, the trajectory for reduction has tended to be seen to be shorter, with the average of 14 economic forecasters now projecting CPI at 3-4% next September.

The implications of policy announcements towards energy price caps (domestic and business) could also have a significant impact on the level of CPI next September. For example, one report has suggested that the cap on energy prices could have as much a 5% impact on overall the level of CPI[9].

8.2 Rent increases beyond 2025

If it is assumed that CPI falls back towards its long term projection of 2% from 2025, it is likely that providers' boards and members will revert to CPI+1% for rent increase policies in line with former business plan projections.

However, we find the potential differences in approach between different providers to be a significant factor in future business planning between LAs and RPs.

[9] BBC report 23/9/22

8.3 Convergence to formula rents

Should the government cap rent increases in April 2023 but allow, as per the consultation paper, relet at target rents in line with the formula having increased the full CPI+1%, the following are key findings from our research and analysis.

Relet rates across the social housing stock vary widely but a consolidated average of no more than 3-5% annual churn is experienced across the sector as a whole, and in some cases (e.g for houses in London), this is considerably lower. Some properties churn more than once in a 30 year business planning period, some not at all.

Our estimate is therefore that only around 75% of stock will turnover in a 30 year business planning period.

The impact of this is that the loss of net revenue is never fully recovered, and to the extent that there is any recovery, it is gradual and extends over decades.

We have modelled “catching up” to formula rents over 5 years and 10 years across both sectors in order to test the implications on future rent increases over such these periods. Such a catch up process could be via a fixed period and add increases above CPI+1% for the relevant period:

Assuming CPI+1% for April 2023 is 11% and…

- Rent increases capped at 5%: average rent increases over a 5 year catch up period CPI+2.2% and over a 10 year period CPI+1.6%.
- Rent increases capped at 3%: average rent increases over a 5 year catch up period CPI+2.6% and over a 10 year period CPI+1.8%.
- Rent increases capped at 7%: average rent increases over a 5 year catch up period CPI+1.8% and over a 10 year period CPI+1.4%.

It should be noted that we have engaged around 20% of local authorities during the course of this and other research and in not one authority did officers feel that members would have the appetite to increase rents above CPI+1% for existing tenants from 2024 in order to catch up to formula rents.

This contrasts with RPs where it is felt there would be much more of an appetite to catch up to formula rents over a set period, taking into account pressures on tenants’ income.

9. Commentary on other government policy issues that might affect the assessment (e.g. Right to Buy)

It is understood that there are a number of issues that are informing DLUHC officials’ thinking in setting out the consultation paper.

In overall terms, the Government remains focused on the growth of supply in affordable housing and are therefore likely to want to test the impact of a proposed cap on rent increases on future delivery. We have highlighted some examples of the potential impact above. The combined impact of intervention in future rent policy with uncertainties in the lending markets is likely to mean that providers will be cautious about committing to large programmes beyond the current Strategic Partnership round – and in the latter case there are likely to be additional impacts on delivery timeframes given the challenges around supply chains and contractors.

A commitment to a longer-term rent increase policy at CPI+1% is felt to be particularly important to enabling continued investment by traditional non-profit RPs and new entrant For Profit RPs, particularly given the increased costs of finance which are likely to prevail for the medium-term (i.e. higher costs of borrowing).

Additional impacts under consideration might include:

- The impact on quality and standards in the light of extensive adverse publicity (around for example damp, mould and condensation); whether net loss of income might lead to reductions in planned maintenance programmes and in turn risk deterioration of standards, increased repairs costs and increased disrepair claims.
- The potential impact on households which pay some or all of the rent: in particular the high "marginal impact" on households on partial benefit where other elements of household bills are also increasing significantly above wages. CIH research during the summer highlighted that for one large London-based RP, 25% of residents regularly found their rent unaffordable, 35% are already finding that they have "nothing left" after meeting all essential outgoings. Our research suggest that cost of living pressures already play into the current (2022/23) financial year with an increased risk of arrears at up to 10-15% of rent across the whole sector.
- The impact of inflation on energy, food and transport costs for households is likely to mean that paying rent is subject to further "diversion" to other essential costs (assuming as it conventional that paying rent would be the first of the essential costs to be reduced)[10] even before any rent increase for 2023 is considered. Assuming a low-end forecast for inflation in other household essentials of c10% for food, 5% for transport and recent increases to the energy price cap (before September 2022), we estimate the impact on households in the lower quintile of incomes, is that up to 25% of rent may be at risk of being "diverted" in this way[11].
- The parallel increases in interest rates and mortgage costs coupled with no significant fall in house prices experienced since the pandemic tend towards there being no specific driver towards greater Right to Buy volumes as a result of rent increases at higher rates. Even if rents were to increase 11%, mortgage interest rates are likely to increase proportionately higher.

10. Consider any options for restraining rent increases that the sector might offer and their implications

Whilst this element of the work has formed the basis of initial discussions with providers, assuming that the government's consultation process will result in the imposition of a cap on rent increases at some level for April 2023, the room for manoeuvre for providers has reduced considerably.

There is no doubt that without a cap most (if not all) providers would have exercised restraint on increasing rents at the full CPI+1%.

[10] Savills research based on JRF quintile household spending analysis 2020
[11] Savills research and analysis drawing upon JRF household spending by income quintile: https://www.jrf.org.uk/data/household-spending

There are two points to highlight:

1. Our feedback from local authority officers is overwhelmingly that a rent cap might afford them a better opportunity to achieve any form of rent increase, given that many members might otherwise want to restrain increases further than such a cap.

   Many have indicated that a rent increase at 5% is more likely to be deliverable with a government cap than if the process was left entirely voluntary.

   It is still felt that would be a small number of authorities, particularly those with impending contested elections next May, that would restrict rent increases to lower than 5%.

2. The Rent Standard locks in rent increases to a level lower than target/formula increases for existing tenants.

   Unless the Rent Standard allows some form of "catch up" to formula rent, the imposition of a cap or the voluntary restriction of rent increases would have the same effect.

   An appeal by providers for a cap not to be imposed but to offer voluntary restraint would still therefore require amendment to the Rent Standard in order to allow catch up to formula over time.

11. Considerations relating to service charges and service charge increases

Whilst the government's consultation paper makes brief reference to service charges, highlighting that these are not subject to the Rent Standard and therefore not able to be influenced by national policy, there is an implication that the government wishes providers to exercise restraint and for providers therefore to consider restricting increases in line with rents.

A large component of service costs relate to communal heating, lighting and electricity. Best practice offered by providers would recover service costs £ for £ usually through a mechanism in which a budgeted amount is charged in one year and the actual adjusted in the subsequent year.

The scale and amount of service charges varies enormously between providers.

However our research and engagement with providers highlight the following:

- Historically local authorities may not have levied separate service charges, pooling rent income across all tenants and all costs. The de-pooling of rents to separate service charges has proceeded for 20+ years, also driven by the need to recover costs from leaseholders, and we note is more or less complete for all RPs (although there are likely to be some continued local exceptions).
- Where there are high numbers of leaseholders, for example in London, rent pooling is not common.
- However in many cases, this process has not been completed by local authorities. Our estimate is that around 80% of authorities have not fully de-pooled service charges.

As a result of inflation in energy, repairs and housing management costs, it is likely that service cost inflation is running well above CPI. For those service charges with a high component of energy costs, we would expect these to be much higher. For example, if communal heating charges are (say) £5/week in 2022/23, a five-fold increase passed on directly would increase that component of the service charge to £25/week.

Notwithstanding the announcement of energy caps for providers (*details tbc*) increases at this rate are unlikely to be sustainable for providers and tenants.

There is therefore a risk of a mismatch between service costs and charges in turn risking a degree of "re-pooling" of rents.

RPs may take the view that a form of "catch up" on service charges would be appropriate over time. For many LAs, our research suggests that any re-pooling of rent income would likely stay in place for much longer periods of time.

12. Feedback as to how members and boards are viewing rent increases in the light of cost of living pressures on tenants

12.1 Cost of living mitigations

Up to two thirds of tenants are on some form of Housing Benefit/Universal Credit support for rents and benefitable service charges, with around three-fifths of income covered by benefits. Many providers have recognised that a full CPI+1% rent increase in April 2023 would be covered to this extent by benefits, focusing hardship on those required to pay their rent, particularly those on partial benefit.

One response has been to consider "rent relief" funds developed by charging the full rent increase and allocating funds to cover hardship for those unable to pay the full increase.

Our research and engagement with providers suggests that a significant minority of RPs (more rarely LAs) have such an approach under detailed consideration, but that a larger number consider the approach to be inappropriate.

It is understood that feedback from many tenants and residents groups is that the approach is unpopular, the key line being that unaffordable rents should not be charged in the first place.

The capping of rents will reduce options for providers to implement such measures in any case as net operating margins will reduce.

12.2 Shared ownership rents

This kind of approach has also been extensively discussed by RPs in the context of shared ownership rent increases where the RPI+0.5% annual indexation driver is likely to drive 10%+ increases, at a time when mortgage rates are also increasing. The approach is characterised by implementing the full increase to headline rent levels, but opting to charge a lower increase in the next year (or two) followed by a catch up thereafter. Legal advice has been received that suggests that such an approach is able to be implemented and therefore an option for boards to consider.

Savills Affordable Housing Consultancy
October 2022

Annex 1

Blended inflationary drivers from our research

	2022.23	2023.24	2024.25	2025.26	2026.27	2027.28
General CPI		10.00%	6.00%	4.00%	2.00%	2.00%
Pay award LAs	5.00%	6.00%	4.50%	3.00%	3.00%	3.00%
Pay award RPs	5.00%	5.00%	5.00%	3.00%	3.00%	3.00%
Contractors	8.00%	10.00%	7.00%	4.00%	3.00%	3.00%
Supplies/materials	8.00%	10.00%	7.00%	4.00%	3.00%	3.00%
Utilities costs	30%	100%	50%	5%	3%	3%
Construction	7.00%	10.00%	10.00%	5.00%	3.00%	3.00%

** As set out above, these estimates are based on a blend of indices data (which vary monthly) and experience of feedback from RPs and LAs, set as an average across both sectors; we might usefully state that we would expect these to be a minimum for modelling purposes.*

Valuation assumptions September 2022 (Quarter 4)

Savills Assumptions September 2022 - CPI Base			Major Works Cost Growth		Maintenance Cost Growth	
	Annual CPI (general)	Q4 CPI (rents)	Nominal	Real	Nominal	Real
2022/23	8.50%	10.00%	9.05%	0.55%	8.35%	-0.15%
2023/24	5.10%	4.50%	4.10%	-1.00%	4.10%	-1.00%
2024/25	2.50%	2.50%	4.00%	1.50%	3.15%	0.65%
2025/26	2.50%	2.50%	3.50%	1.00%	2.95%	0.45%
2026+	2.00%	2.00%	2.50%	0.50%	3.00%	1.00%