Increasing investment in affordable housing

3 April 2014

Towards a level playing field for affordable housing

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A report by Capital Economics for Shelter

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CONTENTS

1 SUMMARY AND RECOMMENDATIONS

Capital Economics has been commissioned by Shelter to research and report upon the financial mechanisms that could lead to additional investment in affordable housing.[1]

In Britain, there are simply too few homes in the right locations – and we are not building new properties fast enough to close the gap, with an estimated shortfall of over 100,000 newly built homes each year. The misalignment of supply and demand is driving property prices up at a much higher rate than incomes. Indeed, the ratio of house prices to income has risen in fourteen of the last eighteen years. 'Affordable housing' has an important role in ensuring accommodation for individuals and families who might otherwise be priced out of the market.

Until recently, new affordable housing was funded largely by central government grants. However, the budget of the department for communities and local government has been one of the most aggressively squeezed during recent rounds of fiscal austerity, and affordable home grants have suffered accordingly. In the *Spending Review 2010*, the budget for communities, which includes housing, in the department for communities and local government was cut by over 50 per cent compared with a government total of just eight per cent.

The new funding regime places a significant strain on housing associations and other affordable housing providers. The government has sought to increase the level of borrowing that housing associations can secure against their future revenues by permitting higher rent – but it is unclear the extent to which the new higher rents that they can charge will be enough to allow them to secure sufficient debt to viably invest in new homes. The ratings agency Moody's has raised concerns that housing associations have to use higher risk sales to fund developments, with this income being less stable than traditional lettings. Furthermore, part of the regime change will be for housing benefit to be paid directly to tenants rather than the landlord, which will create revenue collection risk for housing associations.

[1] At an early stage, a workshop of industry experts provided input and direction to this project. The participants in the workshop were: Steve Amos, Barclays; John Beresford, Grainger Plc; Paula Hirst, Future Cities Catapult; and Jo-Ann Pepperell, Lloyds Bank; with additional comments from Jan Crosby, KMPG. We are grateful for their valuable input and advice, while recognising that any errors or omissions in this report remain ours.

Meanwhile, building new affordable homes has wider macroeconomic significance, especially as the United Kingdom economy is struggling to recover ground lost since the financial crisis of 2008. (See section 2.)

Despite its economic significance, the financing of affordable housing is not on a level playing field with that of many other government priorities.

In 2013, the average annual cost of funds available to housing associations was 5.0 per cent – 93 basis points higher than the rate at which local authorities borrow and 173 basis points more expensive than general government debt funded through the gilts markets. With total borrowings across the sector of £52 billion in 2012, housing associations are spending £900 million per annum more on interest payments than they would need to if their investment programmes were funded through gilts.

Meanwhile, the terms of the commercial loans extended to housing associations typically restrict their capacity for additional debt to be taken on – and the aftermath of the 2008 financial crisis has had a disproportionate impact on the availability of credit for small and medium sized businesses, who have historically accounted for a large share of new housing construction and development.

Local authorities have the potential to invest significantly in the provision of new affordable homes. But debt caps currently constrain their ability to support their housing programmes through borrowing. These caps mean housing programmes are treated less favourably than other areas of local capital expenditure, for example public realm improvements, cycle schemes, leisure centres and traffic management. Evidence suggests that they would invest £7 billion in new housing if they could borrow according to prudential limits. (See section 3.)

In all likelihood, any potential financing or funding measures to stimulate additional affordable home building will require new government contributions: as direct cash funding, such as a grant or subsidy line; as an asset contribution, such as the gifting or leasing of property; or by taking on contingent liabilities through, for example, risk sharing arrangements.

The coalition government's 'fiscal mandate', which constrains public sector spending and debt, has so far left no room for any increase in direct cash funding for affordable housing. However, the government's finances are finally starting to turn the corner. Now is a sensible time to reassess government spending priorities and mechanisms.

We believe there is scope for a material increase in the affordable housing capital grant budget for 2014/15, and beyond. On the current trajectory of its fiscal position, the government should invest an additional £3.6 billion per annum in grant funding over the life of the next parliament.

However, others – probably including the Treasury – may disagree. In which case, what are the next best alternatives that will stimulate additional building?

Any potential policy to support affordable housing must not worsen the public sector's current budget and/or its net level of debt. It should not impose any additional burden on the government's cash position – either through current or capital expenditure. This limits the choice of interventions to those that either contribute non-financial assets or take on contingent liabilities.

The categorisation of the legal entities that are used to hold debt for affordable housing is also important. If appropriate legal vehicles can be found or created to take on the debt to fund affordable homes investment that are not 'controlled' by government, their borrowing will not count towards the target measures in the fiscal mandate. (See section 4.)

There are various policies and innovations that may help unlock finance for additional affordable housing investment – many of which have already been tried and tested abroad. These include: establishing a housing investment bank similar to that in the Netherlands; creating special bank accounts, like those in France, to provide a cheaper source of capital for housing associations; issuing tax incentivised bonds, as seen in Austria, or long-dated index-linked debt; seeking funds from the European Investment Bank; guaranteeing the lending to builders of affordable houses; writing off or converting to equity the grant already sitting on housing associations' books; using ring-fenced legal entities to allow housing association to borrow off balance sheet; removing the additional debt cap on housing revenue accounts of local authorities; passing control of local authorities' arms-length management organisations from local authorities to tenants to allow them to borrow more without impacting on the public sector balance sheet; and permitting tax increment financing. From these ideas, a package of policies can be formulated that have the potential to stimulate significant additional investment in affordable homes. (See section 5.)

It is time to see affordable housing investment as part of the macroeconomic solution. We have three main recommendations for the government to help boost affordable home building in England and support the macroeconomic recovery:

Recommendation 1:
Borrow to invest using the most cost-efficient sources of funds

There is no reason for the government to be shy of borrowing to invest – especially for affordable housing where the multiplier effects will be substantial and timely.

R1.1: Increase capital grants as quickly and as substantially as possible. Increasing capital grants for housing associations, which are funded out of general taxation and through gilts, is the simplest, quickest and cheapest method to deliver additional new affordable homes. On the current trajectory of its fiscal position, the government should invest an additional £3.6 billion per annum in grant funding over the life of the next parliament. Increasing the amount of grant available per unit would also ensure the development of homes for social rent and further stimulate housing supply.

R1.2: Permit local authorities to borrow to their prudential limits. The debt cap limits on local authorities' borrowing for new housing investment are arbitrary, distorting and counter-productive. Local authorities should be permitted to borrow for housing under the same conditions as their borrowing for other investment.

Recommendation 2:
Recognise the inconsistencies in public sector accounting and act to reduce their perverse effects

The targeting of the public sector net debt rather than other equally sensible measures by the government is disproportionately detrimental to affordable housing investment.

R2.1: Focus on general government rather than public sector debt. Although the government should not dispense with monitoring and targeting public sector net debt, it should place greater focus on the general government measure – and permit greater flexibility for public corporations to borrow. Provided there is transparency and the borrowing is for capacity-enhancing investment, capital market investors will not worry.

R2.2: Reconstitute councils' arms length management organisations (and similar local authorities' activities and organisations) as private not-for-profit organisations. As councils are required to operate their housing activities on the basis of self-sufficiency, there is little to be gained from keeping them within the public sector umbrella. Outside of government control, tenant-owned trusts or similar entities will be able to borrow without detriment to the public debt measures – although will need government guarantees to access cheaper finance.

Recommendation 3:
Establish fit-for-purpose institutions to deliver more and cheaper finance to housing associations and others in the affordable housing development chain

The structures and mechanisms to fund affordable housing investment could scarcely be more complicated or costly – and, critically, they make poor use the government's ability to leverage cheaper finance in capital markets.

R3.1: Ensure that the 'affordable homes guarantee programme' delivers on its promises. There is much to commend the newly announced scheme to underwrite housing associations' borrowing for new affordable homes, especially as an intermediate measure to a more comprehensive and cost-effective solution. However, this needs to be a programme (or the stepping stone to a programme) that has time horizons beyond 2015 to ensure that it provides confidence to the sector and its investors.

R3.2: Build and improve upon the 'Network Rail model' to establish a new funding platform. Constituted as not-for-dividend institutions which are not controlled by government, the platform can raise debt outside of public sector borrowing constraints – while obtaining cheap rates through guarantees partially backed by the Treasury. The platform should include:

R3.2(A): A housing investment bank focussed on providing finance to the housing association sector. A national housing investment bank should have the economies of scale and the specialised expertise to deliver cost effective loans to housing associations. With its liabilities partly guaranteed by the Treasury, it will be able to issue debt to the open market at favourable rates without detriment to the government's favoured public sector net debt measure.

R3.2(B): Special-purpose tax-free 'housing bonds' savings accounts to provide a cheap source of capital. The creation of a new form of tax-free individual savings account, which is marketed and distributed by existing retail banks for a commission, to provide additional low-cost funds for the housing investment bank.

R3.3: Extend the existing 'Help to Buy' scheme to include 'Help to Build'. The government is already providing partial guarantees for home purchases. Extended the scheme to assist small and medium sized construction and development firms wanting to build affordable homes will help unwind some of the adverse credit rationing that that sector has been facing since 2008.

R3.4: Deploy publicly owned land to improve the viability and bankability of projects. With land acquisition accounting for a large proportion of the development costs of new housing, the public sector can utilise its own portfolio of property with housing associations and developers to deliver housing schemes that require less up-front financial investment.

(See section 6.)

Implementing the recommended package has the potential to deliver a material increase in affordable house-building, as well as making a modest contribution to the number of homes built for open market sale. The additional homes are calculated against the current affordable homes programme package and assume a fixed level of grant funding. The number of homes that could be built for social rent if grant levels increased are not, therefore, taken into account.

Figure 1: Estimates of potential impact on housing output

Additional new homes built per annum	Affordable	Open market	All	Spending on new homes (£ millions)
Reducing housing associations' cost of funds by 100 basis points through:				
ia) A housing investment bank; and/or *ib) Special-purpose tax-free 'housing bonds' savings accounts*	5,145	2,232	7,377	1,055
Guarantees for small and medium sized enterprises				
i) Extending 'Help to Buy' to 'Help to Build' for small and medium sized enterprises	1,280	2,377	3,657	523
Loosening housing associations' financing restrictions through:				
i) Ensuring the 'affordable homes guarantee programme' delivers on its promises	2,500	-	2,500	358
Loosening local authorities' financing restrictions through:				
i) Permitting local authorities to borrow to their prudential limits; and/or *ii) Focusing on general government rather than public sector net debt; and/or* *iii) Reconstituting ALMOs as private not-for profit organisations*	9,800	-	9,800	1,401
Deploy publicly owned land through:				
i) Local authorities leasing land to housing associations, who share rental income stream	6,839	-	6,839	978
Total	**25,564**	**4,609**	**30,173**	**4,315**

Source: Capital Economics' own calculations

The total potential impact is estimated at around 30,200 new homes each year, of which almost 25,600 would be affordable. (See Figure 1.) This would support 71,000 additional jobs in the housing construction industry alone and yield an annual saving to HM Treasury of £2.4 billion through a higher tax take and lower benefits spending.

What's more, the policies in the recommended package would not lead to a rise in general government debt and only some may lead to a rise in public sector net debt. (See Figure 2.)

Figure 2: Potential impact on government borrowing and liabilities

Policy	Increase in general government debt?	Increase in public sector debt?	Generates public sector contingent liabilities?
Special-purpose tax-free 'housing bonds' savings accounts	No	Not necessarily	Yes
National housing investment bank	No	Not necessarily	Yes
Guarantees for housing associations	No	No	Yes
Guarantees for small and medium sized enterprises	No	No	Yes
Relaxing local authority borrowing constraints	No	Yes	No
Deploying publicly owned land	No	No	Not necessarily

Source: Capital Economics

(See section 7.)

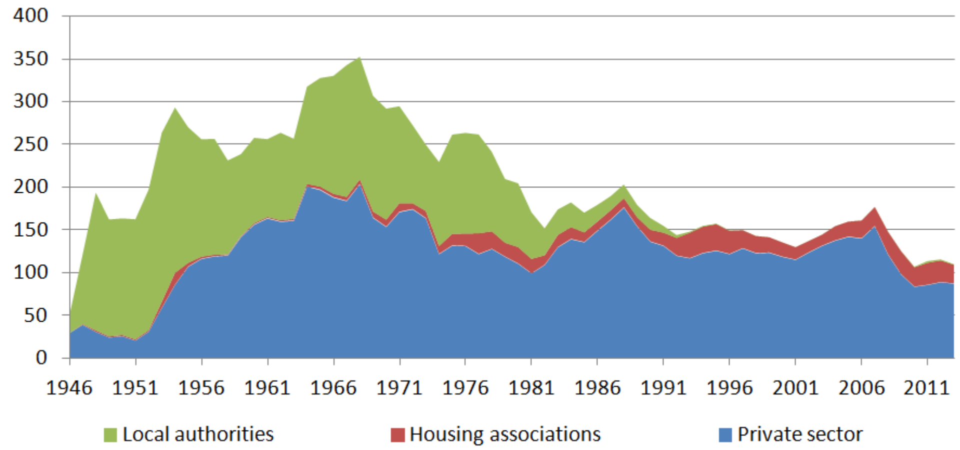
2 BACKGROUND AND CONTEXT

In this section, we outline the background and context to the funding difficulties facing the affordable housing sector. In particular, we set out briefly the role of affordable housing within the overall context of Britain's housing shortage, review how its funding has changed over recent years, and explain the key details of the current funding regime.

2.1 Britain's housing shortage

In Britain, there are simply too few homes in the right locations – and we are not building new properties fast enough to catch up. Growth in demand for accommodation is outstripping any increases in supply; after the 2008 financial crisis, rates of new home completions have tumbled from what were already mediocre levels historically. (See Figure 3.)

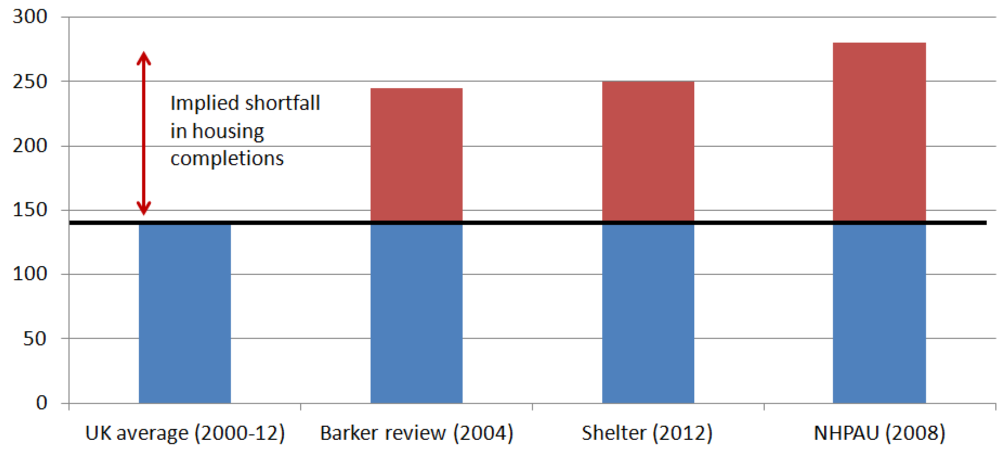
Figure 3: Annual housing completions in England by tenure, thousands



Source: Department for Communities and Local Government Live Table 244: permanent dwellings completed, by tenure, England, historical calendar year series

There is broad agreement that the rate at which homes are being built in the United Kingdom is at least 100,000 units lower per annum than is needed to keep pace with rising demand. (See Figure 4.)

Figure 4: Current housing completion rates against required completion rates to meet housing demand in the United Kingdom, thousands per annum



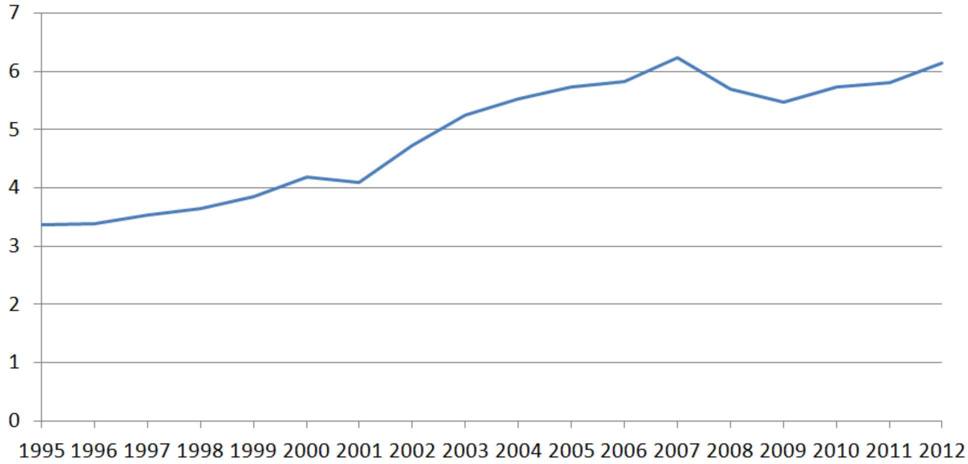
Source: DataStream; Kate Barker, *Review of housing supply* (HMSO, Norwich), 2004; Matt Griffith and Pete Jefferys, *Solutions for the housing shortage* (Shelter, London), 2013; National Housing and Planning Advice Unit, *Meeting the housing requirements of an aspiring and growing nation: taking the medium and long-term view* (National Housing and Planning Advice Unit, Titchfield), 2008.

The misalignment of supply and demand is driving property prices up at a much higher rate than incomes. This is especially the case in areas where local economies are faring well relatively, such as in London or the south east of England – but also, generally, in major urban areas more widely across the country and many of the more sought-after rural communities.

Across the whole of the United Kingdom, the average price of a house was £230,000 in 2012, which compared to the average household gross income of £37,440.[2] This multiple of 6.2 is now at the same level as the peak in 2007, and has risen in fourteen of the past eighteen years. (See Figure 5.)

[2] Source: Office for National Statistics Family Spending 2012, Table A44; Office for National Statistics, Table 25 Housing market: mix-adjusted house prices (previously Department for Communities and Local Government Table 507).

Figure 5: United Kingdom average house price to average annual household gross income



Source: Office for National Statistics Family Spending 2012, Table A44; Office for National Statistics, Table 25 Housing market: mix-adjusted house prices (previously Department for Communities and Local Government Table 507).

But these national averages hide a starker picture in certain locations and for certain household types. In London, the ratio of average house price to average household income has risen from 6.3 in the period 2002-05 to 7.6 in 2010-12.[3]

For lower income families, the stretch is even further. Families in the lowest quintile of income, with an average weekly gross income of £168, spend 22 per cent (£37) of it on housing rent, but this would be 72 per cent (£121) without housing benefits, rebates or allowances, or 49 per cent (£82) of it on mortgage payments.[4]

2.2 The role of affordable housing

In this context, 'affordable housing' has an important role in ensuring accommodation for individuals and families who might otherwise be priced out of the market.

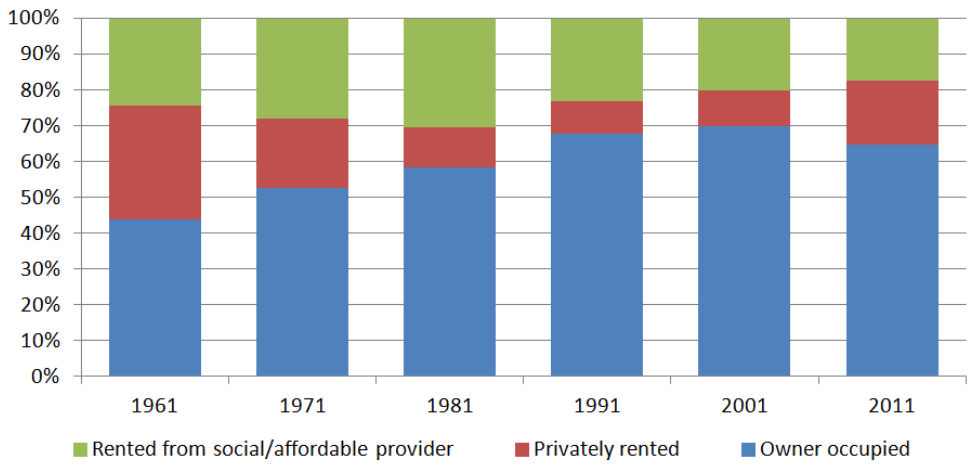
By affordable housing, we mean properties purposely rented or sold below market value to specified eligible households whose needs are not met by the market. This includes: 'social housing', where rents are fixed by government; 'intermediate rent' and 'affordable rent', where rents are fixed at a higher

[3] Mix adjusted house price data from: Office for National Statistics, Table 25 Housing market: mix-adjusted house prices (previously Department for Communities and Local Government Table 507); Income data from Office for National Statistics, Family Spending, Edition 2005 and Edition 2013.
[4] Office for National Statistics, Family Spending, Edition 2013 Tables 2.10 and 3.11. Data for 2012.

level than social rents, but still at less than open market value; and 'affordable homeownership', where houses are sold below market value.

Although some have reformed and revised the regime, successive governments of all political persuasions have recognised the need for affordable homes. Indeed, there is a lengthy history in Britain of affordable housing provision for the needy, which dates back to the tenth century when the first of the almshouses were established. In 1890, the *Housing of the Working Classes Act* established a role for the state and taxpayer funding for what would become 'council homes'. Local authorities were the locus of affordable housing provision and investment up until the 1980s, when reforms started by the Thatcher government led to many council homes being transferred to (and new investment being made by) not-for-profit private organisations, such as housing associations.[5] Today, around seventeen per cent of housing (four million homes) in England is rented from a social or affordable housing provider – although this share was as high as 30 per cent as recently as 1981. (See Figure 6.)

Figure 6: Housing stock by tenure



Source: Department for Communities and Local Government Table 104 Dwelling stock: by tenure, England (historical series)

How then do we unlock more new affordable homes? This is a complex problem involving planning, land ownership, construction sector capacity and its supply chain, etc. and Shelter have an ongoing programme of research to look at the various dimensions.[6] In this report, we focus on funding and financing mechanisms alone.

5 In this report, when we refer to 'housing associations' in the modern context, it is short-hand for all organisations directly responsible for affordable housing provision.

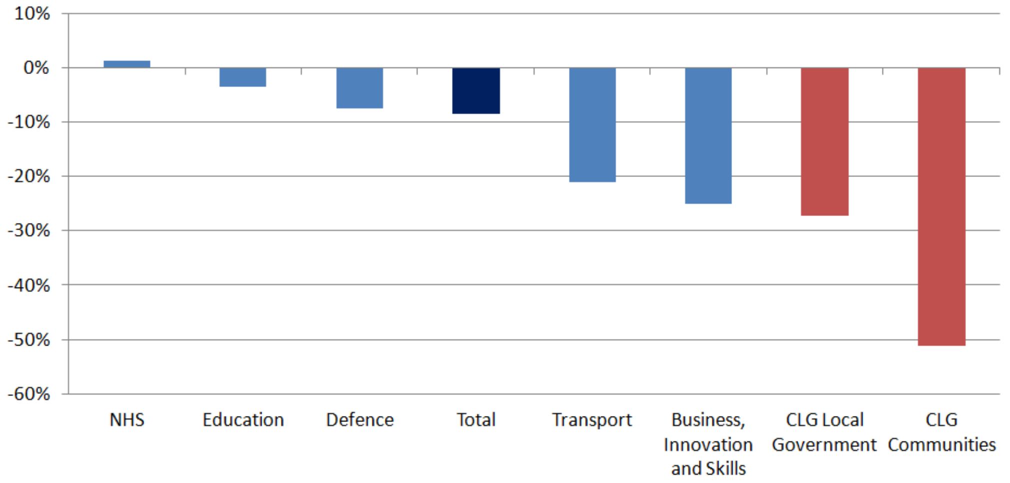
6 Shelter and KPMG, *Building homes for the next generation* (Shelter and KPMG, London), 2014.

2.3 The changing mix of funding for affordable housing

Investment in new affordable housing has been funded through a mix of sources, including central government grants, local authorities' tax revenues and borrowing, debt secured on future affordable rental income streams, 'planning gains' negotiated by local authorities from private property developers, and proceeds from the sale of existing housing stock.

The mix has changed over time. Until recently, new affordable housing was funded largely by central government grants – initially directed to local authorities and latterly more likely mediated via a government agency to a housing association or similar organisation. In the early 1990s, social housing grants provided for around 75 per cent of total cost of developing new affordable homes.[7] The budget of the department for communities and local government has been one of the most aggressively squeezed during recent rounds of fiscal austerity, and affordable home grants have suffered accordingly. (See Figure 7.)

Figure 7: Selected departmental budget cuts in the October 2010 spending review

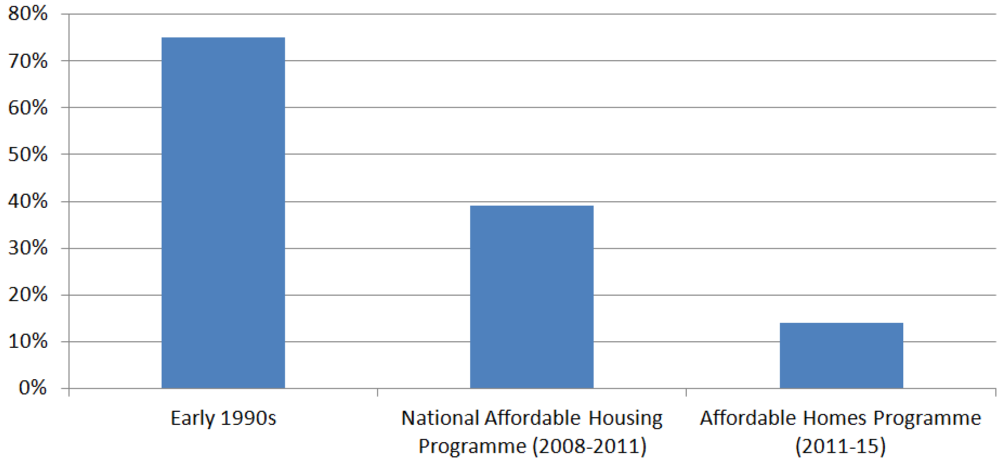


Source: HM Treasury, *Spending Review 2010* (The Stationary Office, Norwich), 2010. Note: Data expressed as cumulative real growth in department budget from 2011 to 2015 as compared with the 2010-11 baseline.

By 2010, grants had fallen to 39 per cent of the overall cost of development. Under the current affordable homes programme for 2011-15, they will provide only fourteen per cent. (See Figure 8.)

[7] Andrew Heywood, *Investing in Social Housing* (The Housing Finance Corporation, London), 2013.

Figure 8: Grant funding as a proportion of total development scheme costs

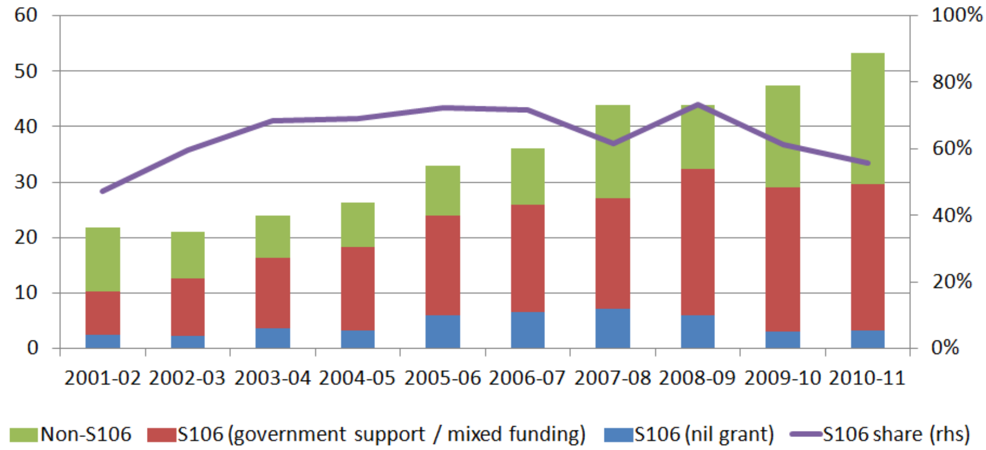


Source: Andrew Heywood, *Investing in Social Housing* (The Housing Finance Corporation, London), 2013. National Audit Office, *Assessing the viability of the social housing sector: introducing the Affordable Homes Programme* (The Stationary Office, Norwich), 2012

As grants have declined, other sources of funding have had to fill the gap.

Through the early 2000s, private developer contributions grew in importance. These so-called 'section 106' contributions, which are set by local authorities as part of the conditions of any planning permission given for an individual development, typically require developers to offer for sale a certain proportion of the new homes they build to housing associations at a discounted value. However, in the aftermath of the global financial crisis of 2008, private house building slowed markedly – and, with it, the scale of developer contributions to affordable housing. (See Figure 9.)

Figure 9: Annual affordable home completions in England, thousands

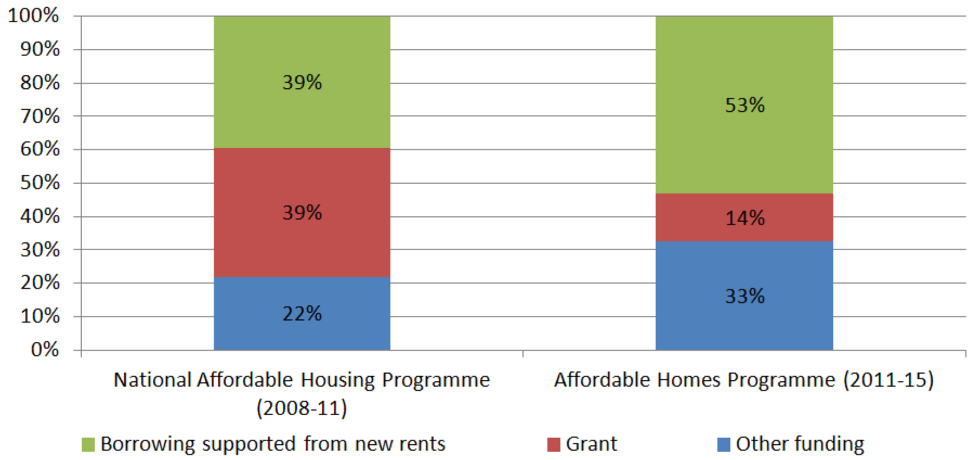


Source: Department for Communities and Local Government, Housing Strategy Statistical Appendix data

More recently, the government has sought to increase the level of borrowing that housing associations can secure against their future revenues by permitting higher rents. Rents chargeable by housing associations on affordable properties are now permitted to be as high as 80 per cent of the market rent prevailing for comparable properties in their area. In 2009 housing association tenants on average paid 67 per cent of the level of the market value of the property.[8]

Overall, the funding mix for new affordable home development is expected to change markedly between the 2008-11 and 2011-15 programmes. Now, housing associations' borrowing against their future rental income is expected to provide over half of funds; "other funding", including section 106 contributions, rises from 22 to 33 per cent. (See Figure 10.)

Figure 10: Share of investment from different funding sources for new affordable housing



Source: National Audit Office, *Assessing the viability of the social housing sector: introducing the Affordable Homes Programme* (The Stationary Office, Norwich), 2012

2.4 Funding new affordable homes under the current regime

The new funding regime places a significant strain on housing associations. It is unclear the extent to which the new higher rents that they can charge will be enough to allow them to secure sufficient debt to viably invest in new homes. The ratings agency Moody's has raised concerns that housing associations have to use higher-risk sales to fund developments, with this income being less stable than traditional lettings. Furthermore, part of the regime change will be for housing benefit to be paid directly to tenants rather

[8] Department for Communities and Local Government, *Review of council housing finance: Summary of commissioned research* (Department for Communities and Local Government, London), 2009.

than the landlord, which will create revenue collection risk for housing associations.[9]

To illustrate the issues under the current regime, we have considered two indicative scenarios:

(i) a new development entirely of affordable homes where the housing association develops and owns the properties; and

(ii) a private development where there is a section 106 requirement to provide affordable homes within the site; these are sold to a housing association at a discounted rate but without any grant support.

We have not considered any scenarios where section 106 schemes are funded through a mixture of developers' contributions and central government grant. Although such an approach has been widespread previously, under the 2015-18 programme, the government's Homes and Communities Agency has stated their expectation that "S106 schemes will be delivered at nil grant input for both affordable rent and for affordable home ownership".[10]

To reflect geographical differences, we have considered the scenarios' characteristics in each of outer London, the east and south east of England, and the rest of England. There are, of course, sizeable differences in unit land and build costs across regions. (See Figure 11.)

Figure 11: Indicative costs of building new homes in England, 2013

	Size of unit (gross internal area, m²)	Land cost per m² of completed gross internal area (£)	Construction cost per m² of gross internal area (£)	Unit land cost (£)	Unit construction cost (£)	Overall unit cost (£)
Outer London	76	1,191	1,241	91,000	94,000	185,000
East + South East	76	740	1,089	56,000	83,000	139,000
Rest of England	76	411	969	31,000	74,000	105,000
Average				**59,000**	**84,000**	**143,000**

Source: Land price data from 2011 Valuation Office Agency Property Market report, converted to 2013 prices using Savills index; construction cost data from homebuilding.co.uk, build costs table August 2013; size of unit is average size of new build properties in the United Kingdom as according to the Royal Institute of British Architects

[9] Gianfilippo Carboni, *English Housing Associations: Lingering Downside Risks Despite Positive 2012 Results* (Moody's Investors Service, London), 2012.
[10] Homes and Communities Agency, *Affordable Homes Programme 2015-18 prospectus* (Homes and Communities Agency, London), 2014.

In the first scenario, housing associations are likely to face substantial funding gaps when developing themselves.

Even with charging rents as high as 80 per cent of market values, we estimate that housing associations outside the south east and east of England will only be able to raise debt to cover three quarters of their development costs. In the south east and east, borrowing is likely to fund 69 per cent and, in outer London, 67 per cent.

Central government grant will, under the current framework, contribute a further fourteen percentage points, which leaves substantial funding gaps to be plugged from other sources. The estimated funding gaps range from £13,000 per unit outside the south east and east of England to £36,000 per unit in outer London. (See Figure 12.)

If the housing associations were able to borrow against the proceeds from the open market sale of the property after a reasonable time (say, 50 years) as well as against the future affordable rental income, the funding gaps would reduce – but are still not eliminated in London, and the south east and east of England.[11]

Moreover, these calculations have been made on the basis of cautious assumptions that are likely to understate any funding gaps.[12]

[11] We have chosen 50 years because the rate of asset sales by housing association is currently equivalent to approximately two per cent of the value of the their total stock. Source: Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013. For illustrative purposes we also cautiously assume that the government writes off grant, which has the effect of reducing the funding gap.
[12] See appendix for details of modelling assumptions.

Figure 12: Indicative viability of a new development entirely of affordable homes where the housing association develops and owns the properties

Per unit	Outer London	East and South East	Rest of England
Assuming no disposal of assets			
NPV income stream	£137,157	£106,734	£86,083
Debt borrowing	£123,441	£96,061	£77,474
Grant	£25,882	£19,455	£14,678
Funding surplus/gap	**-£35,545**	**-£23,877**	**-£12,688**
Loan as % development cost	*67%*	*69%*	*74%*
Grant as % development cost	*14%*	*14%*	*14%*
Funding gap as % development cost	*19%*	*17%*	*12%*
Assuming disposal of assets after 50 years			
NPV income stream	£137,157	£106,734	£86,083
Realisation of future asset sale	£32,193	£25,052	£20,205
Debt borrowing	£152,415	£118,608	£95,659
Grant	£25,882	£19,455	£14,678
Funding surplus/gap	**-£6,572**	**-£903**	**£5,497**
Loan as % development cost	*82%*	*85%*	*91%*
Grant as % development cost	*14%*	*14%*	*14%*
Funding gap as % development cost	*4%*	*1%*	*-5%*

Source: Capital Economics calculations

In the second scenario, the margins made by private developers are reduced substantially when under section 106 obligations to provide affordable housing units that have no grant funding.

Even with rents at 80 per cent of market values, we estimate that housing associations are only able to borrow an average of £123,000 per unit in outer London, £96,000 in the east and south east of England, and £77,000 elsewhere to purchase section 106 affordable homes from developers. These amounts are equivalent to 67, 69 or 74 per cent of total development costs respectively, and 45, 40 or 45 per cent of the value of the units if sold in the open market. (See Figure 13.)

Figure 13: Indicative viability of privately developed sites with 35 per cent of units sold to housing associations under section 106

Short term	Outer London	East and South-East	Rest of England
Open market private developer sales			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£274,785	£242,596	£171,543
Profit per unit	£89,917	£103,630	£66,704
Gross Margin	33%	43%	39%
Affordable housing under s106			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£123,441	£96,061	£77,474
Profit per unit	-£61,427	-£42,906	-£27,365
Gross Margin	-50%	-45%	-35%
S106 development with 35 per cent of units affordable housing			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£221,815	£191,309	£138,619
Profit per unit	£36,947	£52,342	£33,779
Gross Margin	17%	27%	24%

Source: Capital Economics calculations

Assuming an average section 106 requirement for 35 per cent affordable homes in new developments, we estimate the margin to be made by developers is an average of seventeen per cent in outer London, 27 per cent in the east and south east, and 24 per cent elsewhere. These compare to margins of 33, 43 and 39 per cent if there were no section 106 affordable home obligations. (See Figure 13.) If the housing associations were also able to borrow against the potential future proceeds from an eventual open market sale of the property, these margins would increase to twenty, 30 and 28 per cent respectively. (See Figure 14.)

Figure 14: Indicative viability of privately developed sites with 35 per cent of units sold to housing associations under section 106 assuming that the housing association can dispose of assets in the open market after 50 years

Long term	Outer London	East and South-East	Rest of England
Open market private developer sales			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£274,785	£242,596	£171,543
Profit per unit	£89,917	£103,630	£66,704
Gross Margin	33%	43%	39%
Affordable housing under s106			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£152,415	£118,608	£95,659
Profit per unit	-£32,453	-£20,359	-£9,181
Gross Margin	-21%	-17%	-10%
S106 development with 35 per cent of units affordable housing			
Total cost per unit	£184,868	£138,966	£104,839
Unit sale value	£231,955	£199,200	£144,984
Profit per unit	£47,087	£60,234	£40,144
Gross Margin	20%	30%	28%

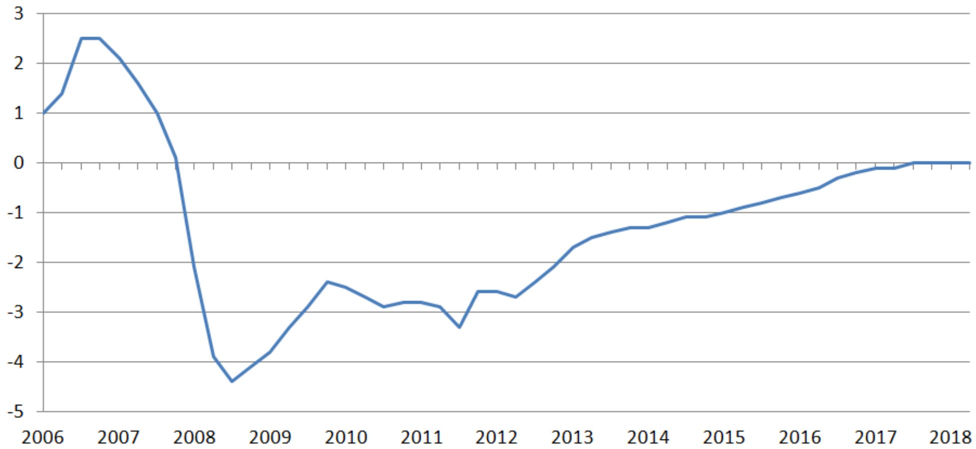
Source: Capital Economics calculations

2.5 The macroeconomic imperative

The issue of building new affordable homes has wider macroeconomic significance, especially as the United Kingdom economy is struggling to recover ground lost since the financial crisis of 2008.

Although the United Kingdom economy is starting to recover from the post-2008 recession, there remains significant spare capacity. The government's independent Office for Budget Responsibility estimates that the 'output gap' stood at 1.7 per cent of gross domestic product at the end of 2013 – and is only slowly reducing. They predict it will fall to zero no earlier than the middle of 2018. (See Figure 15.)

Figure 15: Office for Budget Responsibility's estimates of the output gap as percentage of gross domestic product



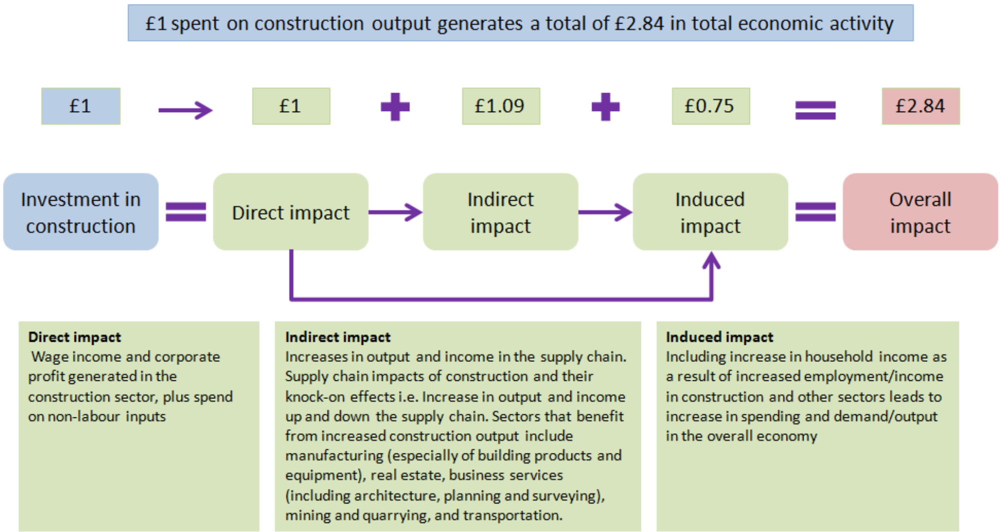
Source: Office for Budget Responsibility, *Economic and fiscal outlook – March 2014* (The Stationary Office, Norwich), 2014. Note: Output gap estimate on a quarterly basis, based on the latest National Accounts data and expressed as actual output less trend output as a percentage of trend output (non-oil basis).

Greater investment in new housing, which will increase construction activity, can help plug the output gap quicker – and in doing so deliver higher economic growth and more jobs. Compared to many other areas of government investment such as infrastructure spending, there are relatively short lead times in housing between making a decision and seeing construction activity on the ground. Unlocking more funding for 'shovel ready' housing schemes is a straight-forward way to support the economic recovery and take up the excess slack created by five years of recession and stagnation.

Moreover, the construction sector is good at stimulating knock-on activity elsewhere in the economy. A report for the UK Contractors Group recently estimated that every pound spent on construction output stimulates an increase of £2.84 in gross domestic product. (See Figure 16.) This large multiplier is, in part, the result of a large proportion (92 per cent) of construction revenues remaining in the domestic economy and not being spent on imported inputs.[13]

[13] L.E.K. Consulting, *Construction in the UK Economy: The Benefits of Investment* (The UK Contractors Group, London), 2009.

Figure 16: Multiplier effect of construction spending in the United Kingdom economy



Source: L.E.K. Consulting, *Construction in the UK Economy: The Benefits of Investment* (The UK Contractors Group, London), 2009

3 THE UNLEVEL PLAYING FIELD FOR AFFORDABLE HOUSING

In this section, we consider whether the financing of affordable housing is being treated equally with other government objectives. In particular, we examine: differences in the costs of funds; the borrowing terms available to housing associations; access to finance by small and medium sized developers and builders; and the constraints on local authorities' borrowing.

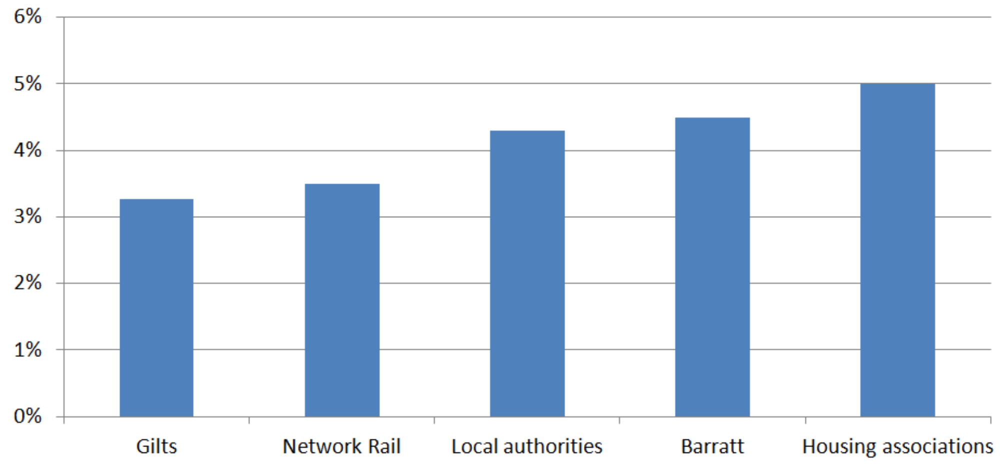
3.1 Cost of funds

In 2013, the average annual cost of funds available to housing associations through bank loans and facilities, and bonds (either issued directly or from the Housing Finance Corporation), was 5.0 per cent.[14] This was 93 basis points more expensive than the rate at which local authorities could borrow from the public works loan board, and 173 basis points more expensive than general government debt funded through the gilts markets. Indeed, it was 50 basis points costlier than the finance available to an exemplar large commercial residential developer, Barratt Developments Plc. Meanwhile, the owner of the United Kingdom's railway infrastructure, Network Rail, which was established as a 'not-for-dividend' entity outside of the public sector, was able to borrow with a government guarantee at 150 basis points less than housing associations. (See Figure 17.)

With total borrowings across the sector of £52 billion in 2012, housing associations are spending £900 million per annum more on interest payments than they would need to if their investment programmes were funded through gilts.[15]

[14] Some of the debt taken on by housing associations for new developments will be at a higher cost than this because of the use of project-specific special purpose vehicles.
[15] Capital Economics calculations. Source: DataStream; Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013.

Figure 17: Comparison of the annual costs of funds, 2013



Source: DataStream; Network Rail Limited annual report and accounts 2013; Public Loans Work Body; Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013; Barratt Developments Plc 2013 annual report. Note: Interest rates are for 20 year Gilts, Local Authorities are able to borrow at 80bp above gilts using the 'certainty' interest rate, data for Network Rail, Barratt Development Plc and housing associations is the effective interest rate on underlying debt. Interest rate for housing associations was the anticipated effective interest rate for 2013.

The treatment of affordable housing looks somewhat anomalous against the financing of other government priorities.

Public sector capital expenditure is funded as part of the overall government budget; any difference between total expenditure and revenues is met through the sale of gilts and treasury bills, and through households' savings with National Savings and Investments. The bulk of investment in public sector priorities – defence, education, health, transport, etc. – is funded this way. In 2012-13, public sector capital expenditure amounted to £43 billion.[16] Defence and transport each had annual investment budgets of £7.8 billion, and health £3.8 billion. The 'communities' budget, of which a fraction is housing grant, was £2.5 billion.

So why is affordable housing being funded at rates much higher than gilts when other government programmes are effectively able to access the cheapest of funds?

Of course, not all government capital programmes are financed out of the general budget. In recent decades, successive governments have attempted to push the financing of capital expenditure projects off its books and into the private sector through the likes of the 'private finance initiative' and 'public private partnerships'. But investment via such initiatives remains the exception rather than the rule; the net book value of private finance initiative

[16] See Table 1.9 in HM Treasury, *Public Expenditure Statistical Analyses 2013* (The Stationary Office, Norwich), 2013.

assets at 31 March 2012 stood at £38.7 billion – only five per cent of overall 'whole government' non-financial assets.[17]

Meanwhile, some public sector investment is conducted by parts of the state that, in themselves, do not have access to the gilts markets. Local authorities, for example, typically access public debt via the public works loan board. Councils have to pay a higher rate of interest back to the quango than the Treasury pays on gilts – typically 80 basis points above gilts for no-risk loans or 100 for riskier commitments. The cost to the public sector as a whole of the finance provided by the loan board to the councils is the gilts rate, but the local authorities have to make their investment decisions, including those relating to affordable housing, based on a higher hurdle rate.

In 2013, housing associations would have needed their funding costs reduced by 93 basis points to match local authorities' best achievable rates from the public works loan board and by 173 to match gilts.

We have modelled the reduction in cost of funds affecting both the number of affordable homes built by housing associations and also by private developers through section 106 requirements:

(i) We assume that the homes built by housing associations are for affordable rent. These newly built homes offer a future rental income stream to housing associations, against which they can borrow. Reducing the cost of funds for housing associations increases the net present value of the future rental income stream. For the same amount of borrowing each year, housing associations are therefore able to deliver the more homes; and

(ii) We assume the homes built under section 106 are bought from the private developers by housing associations for affordable rent, which would provide a future rental income stream to the housing associations. It is usual under section 106 agreements for private developers to be set a requirement to set aside a proportion of units for affordable housing. We have used 35 per cent. As the net present value of the future rental income stream rises, the price per unit that private developers receive from housing associations also increases. With 35 per cent of the development being sold for affordable housing, the mixed development is now more profitable, which incentivises developers to build more units.

Reducing the cost of funds for housing associations to that of local authorities would lead to around 5,000 new affordable homes per annum and 2,000 for

[17] HM Treasury, *The whole of government accounts year ended 31 March 2012* (The Stationary Office, Norwich), 2013.

open market sale in England. If housing associations could access funds at a cost equivalent to gilts, there could be in the region of 7,500 new affordable homes and up to 3,300 homes for open market sale built each year. (See Figure 18.)

Figure 18: Impact of reductions in housing associations' cost of funds in England

Increase in completions per annum	Affordable	Open market	All
1. Cut in HA cost of funds to LA rates			
S106 build	1,152	2,140	3,292
HA own build	3,780	-	3,780
Total	**4,932**	**2,140**	**7,072**
2. Cut in HA cost of funds to gilt rates			
S106 build	1,756	3,261	5,017
HA own build	5,762	-	5,762
Total	**7,518**	**3,261**	**10,779**

Source: Capital Economics calculations. Note: 1) cost of funds spread over gilts decreases from 173 basis points to 80 basis points; 2) costs of funds spread over gilts decreases from 173 basis points to zero basis points. The total figures assume that all additional units are additive.

(A full specification of the model is in the appendix.)

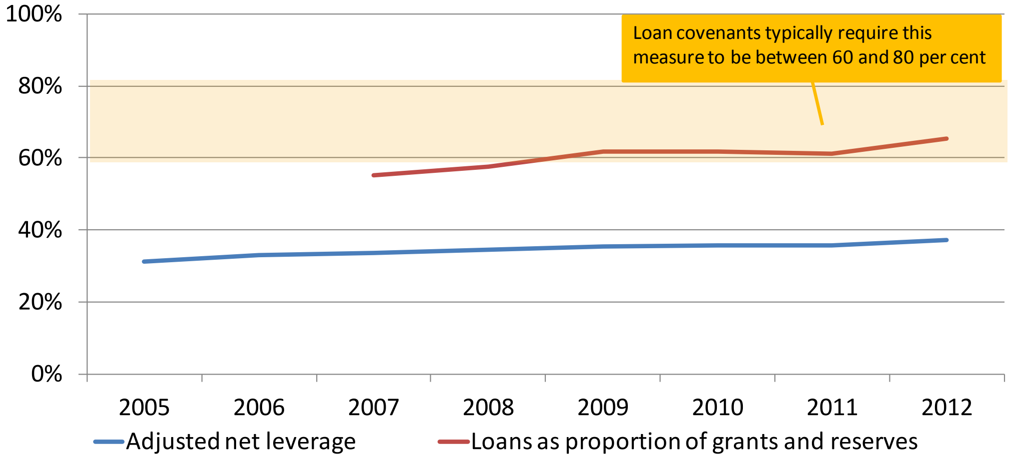
3.2 Commercial terms for housing associations

The terms of the commercial loans extended to housing associations typically restrict their capacity for additional debt to be taken on.

Covenants require housing associations to maintain their overall borrowing within set leverage levels. For many, these constraints are biting. The typical measure used in loan agreements is total loans as a proportion of grants and reserves, and this ratio is usually required to be no more than 60 to 80 per cent. [18] For the 'traditional' sector, where the housing association has not taken on homes through large scale voluntary transfers, there is little spare capacity against this constraint. The ratio was 66.3 per cent in 2012. (See Figure 19.)

[18] Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013 p.27.

Figure 19: Leverage ratios for the 'traditional' housing association sector



Source: Global Accounts of Housing Providers for the years 2007, 2008, 2009, 2010, 2011, 2012 as produced by the Tenant Services Authority and the Homes and Communities Agency

To circumvent covenant restrictions, which are measured against a housing association's own balance sheet position, some new developments are being funded through project-specific ring-fenced entities. These special purpose vehicles have some of their equity (say, ten per cent) provided by the parent association, but the remainder of funds are raised from banks and other lenders/investors at commercial rates. Such 'limited recourse' entities ensure that the debt remains off the housing association's own balance sheet, but the costs of funds are likely to be (much) higher than on-balance sheet rates because lenders will have to factor-in the project-specific risks relating to the particular developments encompassed without the pooling of risk across the housing associations full portfolio.

To build more homes housing associations need the ability to increase their borrowing in a way that does not breach existing loan covenants. Borrowing through the use of special purpose vehicles keeps debt 'off balance sheet', but this is more costly than traditional means of finance. It has been suggested that the additional cost for the government of using special purpose vehicles is in the order of three to four percentage points over gilts.[19] So building of new affordable homes is constrained by the higher cost of special purpose vehicles. To increase output, special purpose vehicles need to be cheaper so they are a viable funding option or covenants eased.

So how much would be built if the covenant constraints were eased?

On current completion rates of 25,360 a year in 2012 in England, housing associations are building 5,530 (or 22 per cent) fewer homes than their peak in 1995. Including local authorities as well increases current completion rates to

[19] Balfour Beatty in written evidence to: The Treasury Committee, *Private Finance Initiative: Seventeenth Report of Session 2010-12* (The Stationary Office, London), 2011.

26,770, but this is substantially fewer than the 159,020 that were built in 1967. We take a cautious estimate of capacity of housing associations to build more at current costs of traditional finance, and assume that they would not return to their 1995 build rates but rather choose to build an additional ten per cent. This would lead to approximately 2,500 new affordable homes being built in England each year. (See Figure 20.)

Figure 20: Additional completions per annum in England

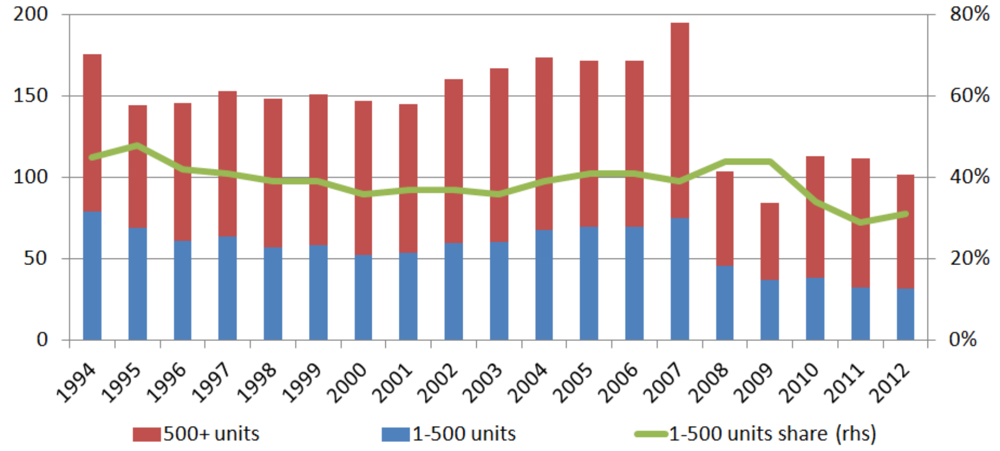
	All social housing providers	Housing associations
Completions per annum		
NB: historic peak in 1967 for all social housing providers, 1995 for housing associations		
2012	26,770	25,360
Historic peak	159,020	30,890
1990s	25,716	22,711
1980s	44,068	12,985
1970s	116,235	13,198
Additional units compared with 2012		
Historic peak	132,250	5,530
1990s	- 1,054	- 2,649
1980s	17,298	- 12,375
1970s	89,465	- 12,162
Percentage increase over 2012		
Historic peak	494%	22%
1990s	-4%	-10%
1980s	65%	-49%
1970s	334%	-48%

Source: Capital Economics calculations; DataStream. Note: Completions by "All social housing providers" are taken as the sum of completions by local authorities and housing associations.

3.3 Adverse credit rationing for small and medium sized enterprises

The aftermath of the 2008 financial crisis has had a disproportionate impact on the availability of credit for small and medium sized businesses, who have historically accounted for a large share of new housing construction and development. (See Figure 21.)

Figure 21: New home registrations by size of house-builder, Great Britain, thousands per annum

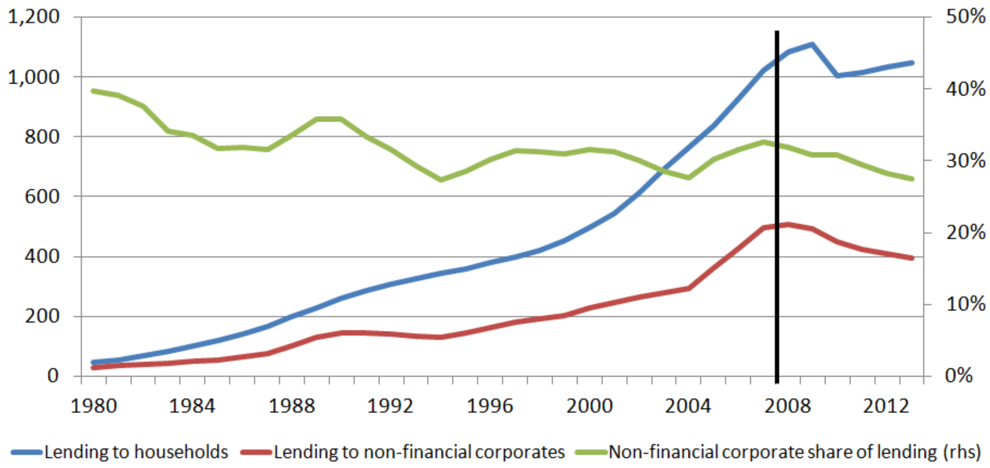


Source: National House-Builders Council data in Matt Griffith and Pete Jefferys, *Solutions for the housing shortage* (Shelter, London), 2013

In general, while banks have kept lending to households broadly stable since 2008, corporates have been deleveraging. (See Figure 22.) Small and medium sized enterprises have felt the full force of this. (See Figure 23.) There has been plenty of speculation about the causes of these trends – with some businesses accusing banks of turning them away, and many bankers arguing that companies haven't had the appetite for debt-funded investment since the financial crisis. There is likely to be some truth in both explanations. But, in the case of small and medium sized enterprises, there is statistical evidence that is indicative of a shortage of finance. Margins on lending to these businesses are currently significantly higher than in 2008-09, and rejection rates have also increased suggesting quantity rationing of credit.[20]

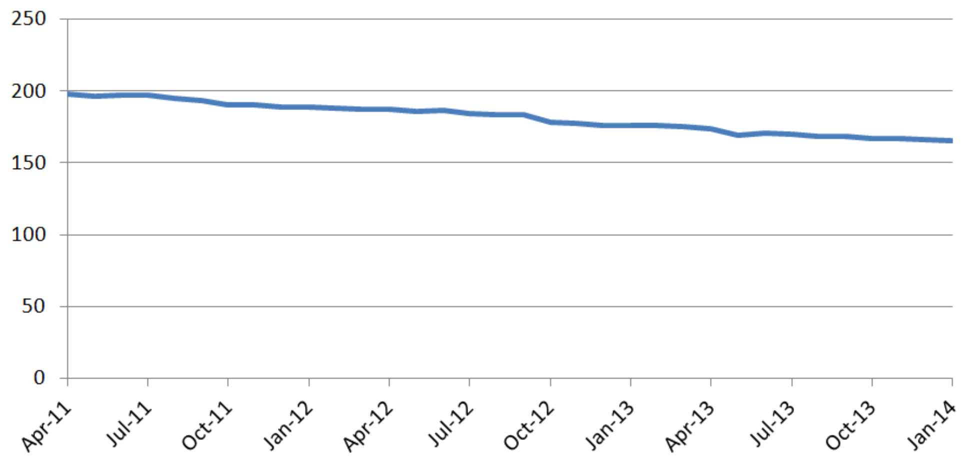
[20] Angus Armstrong, E Philip Davis and Cinzia Rienzo, *Evaluating changes in bank lending to UK SMEs over 2001-12 – Ongoing Tight Credit?* (Department for Business, Innovation and Skills, London), 2013.

Figure 22: Loans outstanding to households and non-financial corporates (£ billions)



Source: DataStream, Bank of England

Figure 23: Bank lending to small and medium sized enterprises, loans outstanding (£ billions)



Source: DataStream, Bank of England

We have estimated the impact of banks reverting to their behaviours prior to the financial crisis so that small and medium sized enterprises face no greater risk of credit rationing than five years ago. In addition, we have considered the potential benefit of reducing the cost of finance for such business to that available to larger companies.

The share of loans outstanding to non-financial corporates of total lending to households (secured borrowing) and non-financial corporates was 32 per cent in 2008. Today, it is 27 per cent. To return to those pre-recession levels, banks would need to increase lending to non-financial corporates by sixteen per cent. It is not unreasonable to assume that lending to small and medium sized enterprises could increase by sixteen per cent as loans outstanding to this group fell thirteen per cent in the shorter time period from December 2011 to December 2013. A sixteen per cent increase in lending to small and medium sized enterprises would be an additional £26.6 billion of loans, based on December 2013 figures.

We assume that a sixteen per cent increase in aggregate borrowing leads to a sixteen per cent increase in output. Based on current levels of small and medium sized enterprises building (19,000 in 2012), this would lead to nearly an additional 3,000 homes per annum. Of these 3,000, applying a typical 35 per cent section 106 requirement, just over 1,000 would be affordable. (See Figure 24.)

To evaluate a reduction in the cost of funds, we model output from small and medium sized enterprises as section 106 new builds. We assume that the homes built under section 106 are bought from the small and medium sized enterprises by housing associations for affordable rent. These newly built homes offer a future rental income stream to housing associations, and this in turn sets the price that the small and medium sized enterprise receives from the housing association for a unit of affordable housing. We set the proportion of units in a new development for affordable housing at 35 per cent.

We assume that there is a two year time period for the construction of a development, and the small and medium sized enterprise receives the sale value at the end of the time period. The net present value of this sale increases when the cost of funds for small and medium sized enterprises falls. The higher net present value of a development leads to increased profits, thus incentivising small and medium sized enterprises to build more. We take a conservative view and model the impact of a 100 basis point cut in the cost of funds for small and medium sized enterprises. This leads to just over 200 new affordable homes each year. (See Figure 24.)

Figure 24: Increase in completions by small and medium sized enterprises

Increase in completions per annum	Affordable	Open market	All
1. Impact of cut in SME cost of funds by 100 bp			
S106 build	216	401	616
2. Impact of SMEs increasing borrowing by 16 per cent			
S106 build	1,064	1,976	3,040
Total	**1,280**	**2,377**	**3,656**

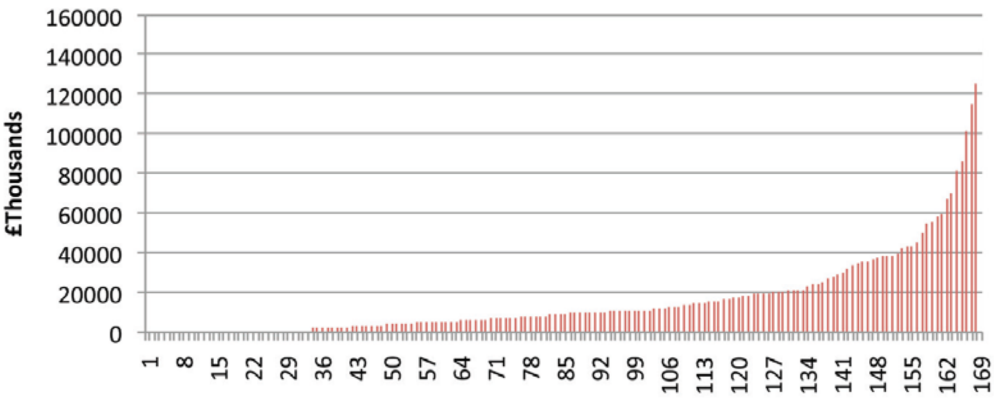
Source: Capital Economics calculations. Note: The total figures assume that all additional units are additive. 1) Reduction in cost of funds from 5.5 per cent to 4.5 per cent. 2) 16 per cent increased borrowing leads to 16 per cent additional output.

3.4 Local authorities’ borrowing constraints

Local authorities are a significant potential conduit for affordable homes investment – either directly through their own developments or in partnership with housing associations or private developers. Ordinarily local authorities borrow for capital investments under the Chartered Institute of Public Finance and Accountancy's prudential code, which was introduced in 2003. It states that a local authority must only borrow when and if the debt repayments and interest are affordable. Additionally, local authorities are currently constrained in their ability to borrow to support their housing programmes by debt caps set out in the *Localism Act 2011*.[21] These debt caps set housing programmes apart from other areas of local capital expenditure, for example public realm improvements, cycle schemes, leisure centres and traffic management.

The combined debt cap for all local authorities' housing revenue accounts amounted to £29.8 billion in 2013, although the amounts are set separately for each authority.[22] In the 2013 autumn statement, it was announced that these caps would be raised by £150 million in each of 2015-16 and 2016-17, but this is immaterial in the context of public sector net debt and in terms of building new affordable housing.[23] The caps were imposed when the new 'self-financing' regime was introduced in April 2012. Under the new regime, councils are allowed to retain the rental incomes from tenants, and plan and control spending over a thirty year period. As councils are not allowed to borrow beyond the debt caps, they are only able to use surpluses from the rental stream to fund new developments. Meanwhile, although there was £2.8 billion of borrowing headroom under the existing cap, this headroom is not shared evenly between local authorities. (See Figure 25.)

Figure 25: Distribution of housing revenue account headroom by local authority



Source: The Association of Retained Council Housing, *Innovation and Ambition: the impact of self-financing on council housing* (The Association of Retained Council Housing, Coventry), 2013

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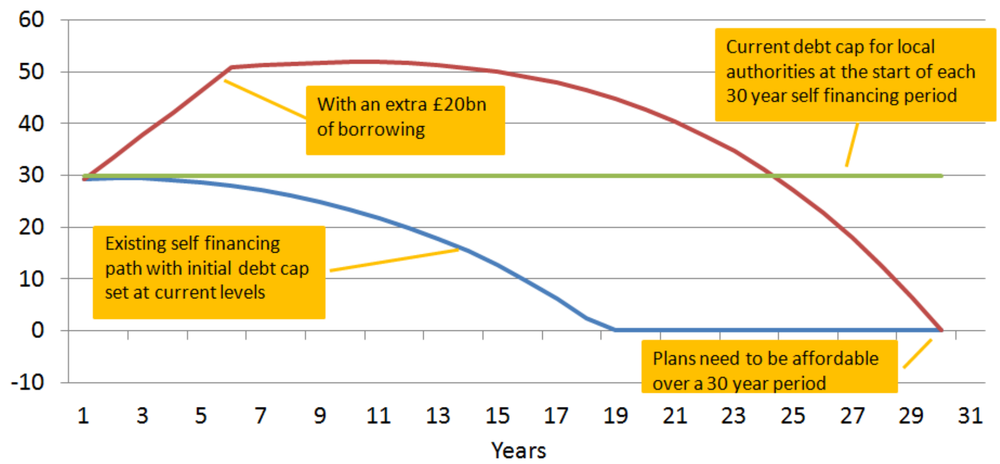
[21] Great Britain, *Localism Act 2011: Elizabeth II. Chapter 20* (The Stationary Office, Norwich), 2011.
[22] See Department for Communities and Local Government, *The Housing Revenue Account Self-financing Determinations* (Department for Communities and Local Government, London), 2012.
[23] HM Treasury, *Autumn Statement 2013* (The Stationary Office, Norwich), 2013.

Some local authorities may wish to develop new affordable housing, but are unable to do so because they don't have sufficient headroom under their cap to borrow more. The different treatment of housing as compared with other local authorities' capital spending appears to have no clear logic. Analysis of the self-financing regime by the National Federation of ALMOs suggests that local authorities could borrow £20 billion more over a five year period for investment in housing without violating the prudential code.[24] (See Figure 26.)

Figure 26: Local authorities' self-financing debt profile (£ billions)



Source: Capital Economics based on John Perry, *Let's get building* (National Federation of ALMOs, York), 2012, and analysis of the 'self-financing model', Department for Communities and Local Government. Available at: https://www.gov.uk/government/publications/the-housing-revenue-account-self-financing-determinations--2

Figure 26 shows the debt profile for local authorities' housing account using the 'self-financing model' available from the department for communities and local government. Over a thirty year time horizon, local authorities could borrow an extra £20 billion over the 2013 caps and finance this through the rental income stream from tenants. This would meet the requirements of the prudential code, since the debt repayments and interest would be affordable; the debt profile will return to zero within 30 years.

If local authorities increased their borrowing by £19.7 billion, an additional 27,500 new homes could be built per annum over a five year period under our cost assumptions or nearly 34,000 on that of others. [25] It is not clear that local authorities would choose to invest all of this extra headroom however. We take a cautious estimate and use a figure of £7 billion that research by the National Federation of ALMOs suggests local authorities would spend on

[24] See John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.
[25] This figure of £19.7 billion is calculated by subtracting the £300 million of announced increases in the debt caps from the £20 billion that was shown to be sustainable.

building new homes if they could borrow according to prudential limits.[26] This would lead to almost 10,000 new homes each year on our cost assumptions.[27] (See Figure 27.)

Figure 27: Additional completions by local authorities

LAs increase borrowing by:	Cost per unit	Total additional units	Additional units per annum (over 5 years)
1. £19.7 billion	£142,891	137,867	27,573
	£116,000	169,828	33,966
2. £7 billion	£142,891	48,988	9,798
	£116,000	60,345	12,069

Source: Capital Economics calculations; John Perry, *Let's get building*, (National Federation of ALMOs, York), 2012.

[26] John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.
[27] This would be 12,000 new homes per annum using the cost assumption of the National Federation of ALMOs in John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.

4 THE NEED FOR GOVERNMENT INTERVENTION

In this section, we start to consider the policy and institutional changes that could help unlock greater funding for affordable housing – and, in particular, the need for government intervention and the fiscal constraints that surround it.

4.1 The necessity of a government contribution

In all likelihood, any potential financing or funding measures to stimulate additional affordable home building will require new government contributions.

If it were possible for the private sector or housing associations to economically build more, one can reasonably assume they would – but returns are too tight for private investors, while projects are too difficult for housing associations to make viable with current grant levels. In some way, state intervention is required to encourage new investment.

There are, however, different ways in which a state contribution can be made – with different implications for government accounting and for the nature of incentives given to others to build new homes. In general, the contribution can be made in one of three ways: as direct cash funding, such as a grant or subsidy line; as an asset contribution, such as the gifting or leasing of property; or by taking on contingent liabilities through, for example, risk sharing arrangements.[28] Only the first of these options necessarily demands tax-payers cash.

4.2 Meeting the fiscal mandate

Since the budget of June 2010, the coalition government's finances have been constrained by the so-called 'fiscal mandate', which has implications for the structure of any government intervention in favour of affordable housing.[29]

[28] The government could also change rules to demand a higher cross subsidy from the private sector, but we do not consider this in the report.
[29] HM Treasury, *Budget 2010* (The Stationary Office, London), 2010.

The primary requirement of the mandate is “to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period”.[30] This objective focuses on controlling the public sector’s current expenditure alone; it does not limit capital expenditure. In principle, borrowing to invest is permitted. However, there is a supplementary target for “public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16”.[31] This objective does not distinguish between current and capital expenditure, and is concerned only with controlling the overall level of state debt. As such, it places a constraint on public sector borrowing regardless of whether that borrowing is being used to fund investment or current expenditure. Meanwhile, both targets relate to the public sector as a whole, i.e. including central and local government, and public corporations.

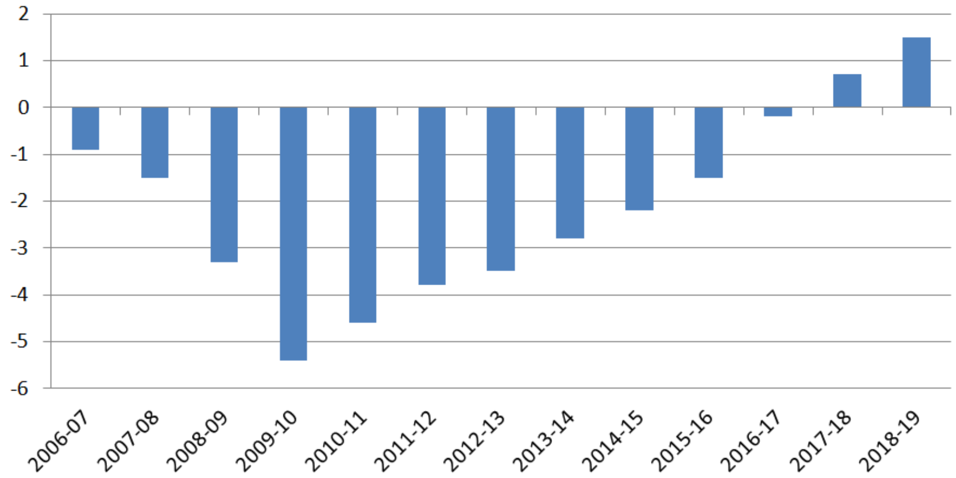
In practice, the fiscal mandate and, more importantly, its supplementary target has so far left no room for the government to increase its direct cash funding for affordable housing.

However, the government’s finances are finally starting to turn the corner. The latest forecasts from Whitehall’s fiscal watchdog, the Office for Budget Responsibility, suggest that the government will meet its main mandate of balancing the cyclically-adjusted current budget before the five year time limit. Indeed, the rule is met by a healthy margin of 1.5 per cent of gross domestic product, or £31 billion, potentially giving the chancellor room to relax policy. (See Figure 28.) The expected drop in borrowing is not yet fast enough for the supplementary target (for the ratio of public sector net debt to gross domestic product to be falling by 2015/6) to be on track. But, if the forecasts are to be believed, the target is now within touching distance. (See Figure 29.)

[30] *ibid*

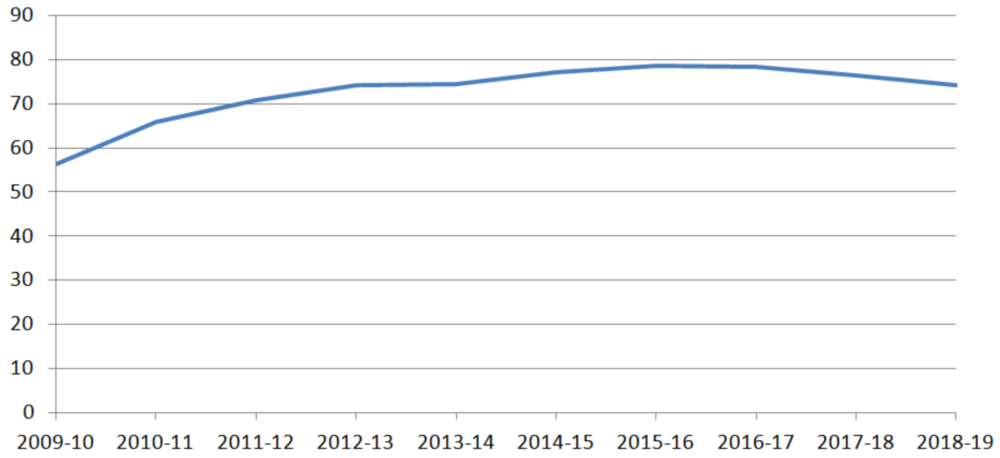
[31] *ibid*

Figure 28: Cyclically adjusted current budget forecasts as a percentage of gross domestic product



Source: Office for Budget Responsibility March 2014 forecast

Figure 29: Office for Budget Responsibility's forecasts for public sector net debt as a percentage of gross domestic product



Source: Office for Budget Responsibility March 2014 forecast

In this context, now is a sensible time to reassess government spending priorities and mechanisms.

As the pressures of the fiscal mandate ease, there should be greater scope for increased direct cash contribution by central government – either as capital grant or even through current expenditure as a subsidy to support housing associations' rental incomes (although the latter seems unlikely given the Treasury's previous decisions in similar areas).

An increased budget for central government capital grant is the most straight-forward, practical and efficient method for stimulating additional affordable homes building. The administrative infrastructure for dispersing grant is already in place, and these mechanisms are well-known to housing associations, developers and relevant civil servants (although there is still room for further improvement). Under the existing system, the moral hazard and other dangers of direct public subsidy are mitigated through competition for its allocation, while both risks and rewards are shared by the public sector, housing associations, developers, private investors and commercial banks. Moreover, central government capital grant is funded as part of the general government budget, which when needed is supported by sovereign debt. These gilt-edged securities are the cheapest form of borrowing available to any player in the affordable housing sector. Using government debt to support capital grant is following the principle of borrowing to invest.

Indeed, housing supply could be stimulated further if housing associations were able to access higher levels of grant funding for the development of housing for social rent. If the policy recommendations in this report were implemented, housing associations could build an additional 6,400 homes for affordable rent. This could be increased by a further fifteen per cent if housing associations were able to build half for social rent with increased grant funding. The cost to government would be only £232 million per annum.[32]

We believe there is scope for a material increase in the affordable housing capital grant budget for 2014/15, and beyond. Indeed, the government is already set to overachieve the fiscal mandate on its current account by £31 billion per annum. If this annual surplus was used to finance borrowing for investment, at today's gilt rates, it would fund approximately £900 billion of capital projects. Even if only, say, twenty per cent of the surplus were channelled into investment, it would still deliver almost £180 billion of new money. This is not unreasonable.

Of course, housing is only one of many public capital expenditure priorities – and other areas will expect their share of any increased government investment. In 2011/12, housing accounted for ten per cent of all government capital spending – which would imply a potential £18 billion increase. Indeed, as recently as 1980/81, housing received a 22 per cent share of public investment, which would translate to £40 billion boost – but for prudence we will focus on an £18 billion uplift alone over a five year lifetime of a parliament. (See Figure 30.)

Figure 30: Gross housing investment and gross public sector capital expenditure, £ millions

	Gross housing investment	Gross public sector capital expenditure	Housing investment share of public sector capital expenditure
1980/81	£3,403	£15,238	22%
2011/12	£5,152	£49,200	10%

Source: Steve Wilcox, *Housing Finance Review 1999/2000* (Chartered Institute of Housing and Council of Mortgage Lenders, Coventry), 2000; Steve Wilcox, *Housing Review 2013*(Chartered Institute of Housing, Coventry), 2013.

[32] See appendix for details.

However, others – probably including the Treasury – may disagree. In which case, what are the next best alternatives that will stimulate additional building?

4.3 Making a contribution without increasing debt

If the fiscal mandate and supplementary target remain as a constraint, any potential policy to support affordable housing must not worsen the public sector's current budget and/or its net level of debt.

Any proposed policy should not, therefore, impose any additional burden on the government's cash position – either through current or capital expenditure. This limits the choice of interventions to those that either contribute non-financial assets or take on contingent liabilities.

Non-financial assets include publicly-owned land and property. Although it may impact upon any notional public sector 'balance sheet' by reducing its assets, a government contribution of land or property to the affordable housing sector would not impact on the government's cash position or on its fiscal mandate measures.

Likewise, the government can enter into risk sharing arrangements with the affordable housing sector, such as guaranteeing some of their debts or income steams, without necessarily causing detriment to the fiscal mandate measures. These contingent liabilities only have a cash impact if and when there is distress or default, and any guarantee is called upon. Only then would the policy have implications for public sector net debt.

4.4 Public sector or general government debt?

The categorisation of the legal entities that are used to hold debt for affordable housing is also important.

The fiscal mandate is focussed on the 'public sector'. According to the Office for National Statistics' definition, the public sector comprises:

- Central government: includes government departments and their executive agencies, non-departmental public bodies, and any other non-market bodies controlled and mainly financed by them

- Local government: those types of public administration that only cover a specific locality and any non-market bodies controlled and mainly financed by them

- Public corporations: market bodies controlled by either central government or local government, including government-owned companies and trading funds

As such, most not-for-profit organisations, including many deeply involved with the delivery of government policies and programmes – such as housing associations, fall outside of the definition of the public sector. The critical issue in determining classification is that of who controls. (See Figure 31.)

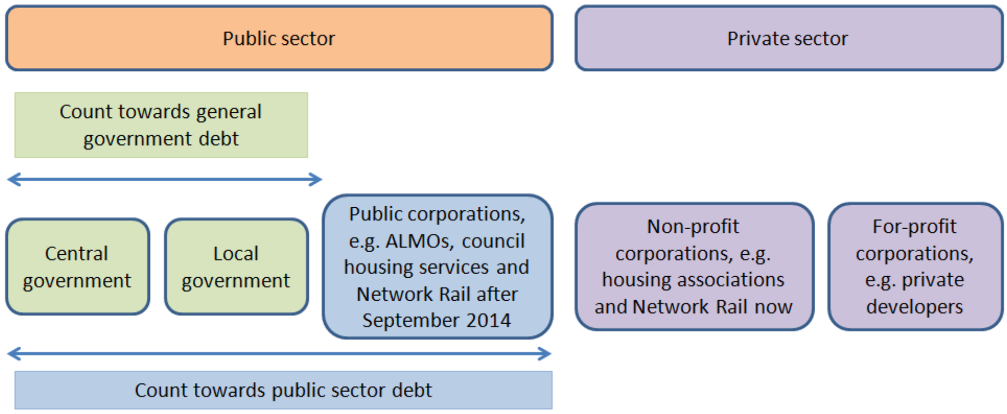
Classification as public or private sector depends on who controls the general corporate policy of the body concerned. Control can be either direct or indirect and may be evidenced by: the ability to appoint the directors, or key directors who determine the policy of the organisation; a right to be consulted over appointments, or to have a veto over appointments; the provision of funding accompanied by rights of control over how that funding is spent; government ownership of a majority of the shares, or special powers for government in the body's constitution may also indicate control; the right to demand certain reports or information, to set or constrain policy, outputs or outcomes, or determine the way in which profits should be utilised; or a general but wide-ranging right to control the day-to-day running of the body.

These rules are getting tougher this year with the implementation by the Office for National Statistics of the *European System of Accounts 2010*.[33] The new European guidance requires the government's statisticians to consider 'control' in broader terms. Importantly, they will now have to consider the degree of government financing of a body and the extent to which there is government risk exposure. Network Rail will be reclassified from the private to public sector as a result. The rail infrastructure body is 65 per cent funded by government grant, but the statisticians do not deem this to represent government control. However, all of its debt is fully underwritten by a guarantee from the department for transport. On this basis only, Network Rail is being reclassified as part of the public sector.

If appropriate legal vehicles can be found or created to take on the debt to fund affordable homes investment that are not 'controlled' (under the new European statistical regulations) by government, their borrowing will not count towards the target measures in the fiscal mandate.

[33] See Theodore Joloza, *Classification of Network Rail under European System of Accounts 2010* (Office for National Statistics, London), 17 December 2013.

Figure 31: Public borrowing definitions and housing



Source: Capital Economics

Meanwhile, there are good reasons to argue that not all public sector debt should be treated the same.

The United Kingdom government targets total debt across the whole public sector. This isn't standard international practice. Many countries monitor and target the general government measure, which includes both central and local government but excludes public corporations. Indeed, general government debt is the focus of the European Union's macroeconomic rules as set out in the 1992 Maastricht Treaty and the subsequent stability and growth pact. Moreover, when analysing indebtedness across countries, respected independent authorities, such as the Paris-based Organisation for Economic Co-operation and Development, conduct their comparisons using the measure that excludes public corporations.[34]

This typological distinction is particularly relevant to the affordable housing sector. The housing services activities of local authorities plus their 'arms length management organisations' fall under the definition of public corporation and, therefore, their financial liabilities are included in public sector debt but not the general government measure.

Had the fiscal mandate followed European and international precedent, and been couched in terms of general government rather than public sector debt, it

[34] For example, the fiscal balances and public indebtedness tables published in the Organisation for Economic Co-operation and Development *Economic Outlook* look at general government rather than public sector; see http://www.oecd.org/eco/outlook/eosources-notestostatisticalannextables25-33fiscalbalancesandpublicindebtedness.htm . For the Maastricht definitions, see http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1993/R/01993R3605-20051223-en.pdf for Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community (OJ L 310, 30.11.1996, p. 7).

would not have limited affordable home investment conducted by public corporations. (See Figure 31.)

Some have argued that it is the demands of the financial markets that have lead to the mandate in its current form – but we're not convinced. We have previously interviewed a number of key individuals in the London bond markets, and they are generally relaxed about the use of general government rather than public sector debt measures (provided there was statistical transparency).[35] Indeed, many said that they would welcome further public corporation borrowing if it were to invest sensibly into infrastructure and the built environment. The markets are positive about the government borrowing to invest.

[35] Capital Economics, *Let's get building: The view from the City* (Capital Economics, London), 2012.

5 POLICIES TO ADDRESS THE FINANCING PROBLEMS

In this section, we summarise various policies and innovations that may help address the problems identified in section 3 of: cost of funds; commercial terms for housing associations' debt; adverse credit rationing for small and medium sized enterprises; and local authorities' borrowing constraints. The 'long list' of ideas contained herein has been generated through discussions with experts, a review of international experience and a desk research exercise.

5.1 Reducing cost of funds

Although housing associations are able to issue long-term debt on the capital markets, they experience higher rates of borrowing than either private sector developers or local authorities. This is not the case in the Netherlands, for example, where housing associations are able to borrow at rates equivalent to local government. Reducing the cost of funds for housing associations would enable housing associations to build more houses and could lead to a greater number accessing capital markets. But how can this be achieved?

5.1.1 Housing investment bank

A national housing investment bank has been suggested by the Institute for Public Policy Research as part of a wider national investment bank, and the idea formed part of Shelter's submission to a parliamentary committee inquiry into the financing of new housing supply in 2012. [36] The committee responded that there was "merit in the suggestion that a national housing investment bank be established. In other European countries such banks have proved effective at channelling investment into new housing development".[37] Furthermore the idea has been advocated its chair, Mr Clive Betts MP.[38]

[36] Andy Hull and Graeme Cooke, *Together at home: A new strategy for housing* (Institute for Public Policy Research, London), 2012. Shelter's submission to: Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.
[37] Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.
[38] See http://www.theguardian.com/housing-network/2012/sep/25/clive-betts-social-housing-investment-banks

With a mandate to lend to providers of new affordable housing units, a national housing investment bank could be publicly owned, set up as a public corporation – or there may be not-for-profit models off of the public balance sheet. The purpose would be to channel investment into new development by offering loans at a lower cost than housing associations or developers would receive on the open market.

This is a long-established model in the Netherlands, where the *Bank Nederlandse Gemeenten* is a specialised lender to local and regional authorities as well as to public-sector institutions such as housing. The bank provides 47 per cent of all lending to housing associations.[39]

5.1.2 Livrét A style bank accounts

In France, special bank accounts have been established to provide funding for housing associations – and this idea has been mooted for the United Kingdom and Australia. [40]

Similar to individual savings accounts in the United Kingdom, French households are able to save into *Livrét A* accounts, which are government backed and provide a secure tax-free interest rate. The accounts are held with local commercial banks (who receive a management fee) but the savings are then pooled by a public corporation, the *Caisse des Dépôts et Consignations*. The short term deposits are then converted into long term loans at below market rates to public and non-profit enterprises to fund affordable housing. Nearly all loans (95 per cent) are guaranteed by local authorities, with the remainder by a mutual 'guarantee fund' that charges a two per cent fee. The scheme provides 70 per cent of social housing finance in France[41] and, in 2011, 120,000 units of social housing were financed out of the savings fund.[42]

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[39] BNG Bank Base Prospectus 3 July 2013 available at http://www.bng.nl/DocsComb/Investors/Base%20Prospectus%20dated%203%20July%202013.pdf?agreecheck=on

[40] Cambridge Centre for Housing and Planning Research, *Funding future homes: appendix – Development and funding models* (Cambridge Centre for Housing and Planning Research, Cambridge), 2012 and Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.

[41] *ibid*

[42] See http://www.caissedesdepots.fr/fileadmin/PDF/presentation_institutionnelle/PresA4_CDC-GB-january2013.pdf

5.1.3 Tax incentivised bonds

Tax incentivised bonds, which are used in Austria, allow providers of affordable housing to borrow at cheaper rates than they would otherwise. [43]

In 1993 the Austrian government created a circuit of capital involving the sale of bonds to channel investment into new affordable housing. These housing construction convertible bonds provide a double tax incentive for investors. The initial cost is income tax deductible for certain groups and the interest coupons are also exempt from the first four per cent of the annual investment income tax charge. The tax privileges make low return bonds more attractive to investors, consequently allowing for low interest loans at up to one per cent below market rates.

Bond issuance for housing associations is already prevalent in the United Kingdom, and although not all housing associations are large enough to do so, they are able to access bond markets through the Housing Finance Corporation. It may be possible to extend tax-relief to investors who buy these bonds and as such reduce the required rate of return enabling housing associations to access cheaper finance. Although this does not require an upfront subsidy, the government would lose out in terms of foregone tax revenue. In Austria it has been estimated that the cost to the government in terms of foregone tax revenue is €120 million per year.[44] It may also be difficult and costly for the tax authority to create a new class of tax exemptions.

5.1.4 Long dated index-linked debt

In 2011, an investment consultancy highlighted the potential for long-dated index-linked debt to support affordable housing investment.[45]

As housing associations receive a rental income stream that is linked to inflation, they may be able to reduce risks for investors by linking their coupon repayments to inflation. By creating greater future investment value certainty for investors, the housing associations would be able to issue bonds

[43] For a fuller discussion, see: Cambridge Centre for Housing and Planning Research, *Funding future homes: appendix – Development and funding models* (Cambridge Centre for Housing and Planning Research, Cambridge), 2012 and Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.
[44] Schmidinger (2009) as reported in Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.
[45] Redington, *Social housing opening new doors for liability matching investment* (Redington, London), 2011.

at a cheaper rate. Providing index-linked bonds might also increase the pool of investors who currently purchase debt from housing associations directly or from the Housing Finance Corporation. However, this is unlikely to provide a step change in the cost of funds, as the inflationary environment in recent decades has been somewhat benign and looks set to remain so.

5.1.5 European Investment Bank funding

The European Investment Bank, the largest multilateral borrower and lender by volume, already provides funds for affordable housing in the United Kingdom.

Owned by and representing the interests of member states, the bank works to implement European Union policy by funding projects that improve economic and social cohesion at below market rates. In 2013, its lending to the United Kingdom reached a new high of £4.9 billion with focus on water and energy infrastructure, rail and port facilities, hospitals and education.

For more than a decade, the Luxembourg-based institution has invested in social landlords in the United Kingdom through intermediary vehicles, such as The Housing Finance Corporation. Indeed, in January, it launched a £500 million lending platform with the corporation to fund development by smaller social landlords. In February 2014, it announced a further step with a new plan to lend £1 billion per annum directly to larger affordable housing providers.

Although the announcement is good news for the British affordable housing sector, there is still much to be done to ensure that the full £1 billion per annum is actually dispersed. The European bank typically lends only third of a project's full value – so large scale co-lenders are needed, while even bankable projects must also meet tough economic, technical, environmental and social standards criteria.

5.1.6 Loan guarantees for social housing

Guaranteeing the borrowings to builders of affordable houses has formed part of the *Livrét A* scheme in France and also that of lending by the *Bank Nederlandse Gemeenten* in the Netherlands.

In the Netherlands, guarantees are provided by the national social housing guarantee fund, *Waarborgfonds Sociale Woningbouw*. The guarantees have been able to cover 80 per cent of loans to the housing sector, reducing rates by a 1.0 to 1.5 percentage points.[46]

Guarantees have also been implemented in the United Kingdom. The affordable homes guarantee was announced in September 2012 as part of the 'Housing and Planning package'.[47] The government has committed to provide guarantees for up to £3.5 billion of registered providers' debt and, in doing so, provide housing associations with access to cheaper funding. The government anticipates that this will lead to an additional 30,000 new affordable homes being built.[48] Subject to demand this scheme could be boosted by a further £3 billion being held in reserve.[49]

5.2 Commercial terms for housing associations' debt

Many housing associations are nearing the maximum gearings permitted under the terms of their existing facilities – so, even if debt is cheap or becomes cheaper, they are not able to borrow more.[50] To take advantage of cheaper finance or even make the most of existing finance available to them, they need to be able to borrow in ways will not breach their existing covenants.

5.2.1 Write-off existing grant

The manner in which housing associations have to account for the grant they receive means that their reported balance sheets potentially understate their underlying borrowing capacity.

Social housing grant dispersed by the Homes and Communities Agency is not simply gifted to a housing association, but comes with conditions. Many of these conditions remain beyond the construction of the properties and relate to their ongoing and future use, as well as the legal, regulatory and financial status of the housing association itself. The grant may be repayable (in part or

[46] Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.
[47] See: https://www.homesandcommunities.co.uk/ourwork/affordable-homes-guarantees-programme (accessed 07-03-14).
[48] See: https://www.gov.uk/government/news/10-billion-housing-guarantees-open-for-business (accessed 07-03-14).
[49] See: https://www.gov.uk/government/news/10-billion-housing-guarantees-open-for-business (accessed 07-03-14).
[50] Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013.

full) to the agency should 'events' specified in the original funding agreement occur; one such event is the disposal of grant-funded property by the housing association.[51] As such, grant remains as a 'repayable charge' (albeit subordinate to the repayment of loans) on the balance sheets of recipient housing associations regardless of the likelihood of it ever being required to be repaid.

Some have argued that the government could write-off grants and, therefore, improve the balance sheets of housing associations.[52]

Something similar has happened before in the Netherlands with *Brutering*.[53] This was a financial operation that settled money owed to housing associations by the state and by the state to housing associations. Since then Dutch housing associations have received no government subsidy. They have funded the building of new housing through a revolving fund generated through the sale of existing and new build properties at market rate.

We have our doubts that the grant write-off would have the desired impact in the United Kingdom. Although grant appears as a payable charge, banks and investors are likely to have made rational commercial judgements about the business significance of the conditions. As such, it is unclear that removing the conditions will make much difference to these views. Moreover, the conditionality of grant is there for policy reasons, especially, to retain properties in the affordable homes sector. It is only appropriate that any decision to write-off grant should only come after a review of the policies behind the grant conditions.

5.2.2 Convert grant to equity

Converting existing grant to equity has been argued for by Places for People.[54] The designation of the historic housing grant could be changed by the government. Housing associations would then be able to sell equity on the market. The income equity payments would be funded by the conversion of social rented void properties into affordable rents. Places for People argue

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[51] In practice, the policy objective is for grant to become repayable if grant-funded property is transferred out of the affordable housing market. As such, certain disposals can occur without repayment. These include: sale to another registered provider; the sale of the first share of an Affordable Home Ownership Dwelling under a Newbuild HomeBuy Lease; and disposal of an affordable rent dwelling to a tenant.
[52] Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.
[53] *Aedes, Dutch social housing in a nutshell* (*Aedes, Den Haag*), 2003.
[54] Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013.

that this model could deliver 160,000 affordable new homes across housing association sector.

However, concerns exist because the housing associations would become for-profit. There are legislative barriers to this happening and it is not an easy process. The Tenant Services Authority expressed concern and that there would be "unknown consequences in terms of balance sheet valuations".[55] Financing through equity is currently more expensive than debt financing, so it is not clear how attractive this mechanism really is.

5.2.3 Special purpose vehicles and real estate investment trusts

The use of ring-fenced legal entities especially established to develop one or more projects can help housing associations deliver new building within their borrowing constraints.

Rather than have the housing association itself take on more debt, a separate special purpose vehicle may be established to conduct new investment. Although the housing association may have equity in the new entity, it is spared any additional liabilities on its own balance sheet or deterioration in its gearing ratios. The proxy organisation may then borrow on its own account from banks, and provide the conduit for other investors and funders in its specific projects. This provides a funding route that circumvents the constraints on the borrowing of the housing association itself; however, it comes at a cost as banks and investors will place a higher risk premium on the project-specific special purpose vehicle.

The principle can be extended further with the vehicle becoming an exchange-traded investment asset, such as a real estate investment trust, so that an even deeper pool of potential investors is accessed. Real estate investment trusts could be used to bring institutional or individual investment into affordable housing and many in the sector support it, including Places for People, the British Property Federation and the Chartered Institute for Housing.[56]

[55] Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.
[56] Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.

5.3 Adverse credit rationing for small and medium sized enterprises

Small and medium sized enterprises have historically provided a large proportion of house building in the United Kingdom. Although the proportion has declined generally over the last few decades, it has fallen more substantially in recent years since the financial crisis. Part of the reason for this has been a decline in lending by banks to small and medium sized enterprises. Policies that could address the allocation of credit to small and medium sized enterprises could then lead to an increase in house building by small and medium sized enterprises, and in turn an increase in affordable housing development.

5.3.1 Loan guarantees for small and medium sized enterprises

The government could guarantee loans for small and medium sized enterprises, which could be conditional on the funding being used for affordable housing development. These guarantees could materially lower the financing costs and allow more firms to access the credit markets and therefore invest in affordable housing.

The government already has several schemes in place to try and get banks to lend to such businesses. In November 2013, the Bank of England and the government announced changes to the 'funding for lending scheme' to further re-focus lending to small and medium sized enterprises. The government is also creating a new business bank that will have £1 billion of additional government funding, which will be managed alongside £2.9 billion of existing government commitments. This is intended to be fully operational in autumn 2014. In addition, there is the 'enterprise finance guarantee scheme' to enable banks to lend to small business that lack the security or proven track record. It is hoped to account for one to two per cent of total lending to such businesses, providing up to £2 billion of additional lending over this year and next.

It is still too early to judge the success of these schemes, but none has focus on affordable housing – nor do they appear to have the scale of the guarantee system in the Netherlands, which has reduced borrowing costs by around one per cent.[57]

[57] Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.

5.4 Local authorities' borrowing constraints

The potential for local authorities and their arms length management organisations to borrow to build new affordable homes is currently heavily constrained. Policies to lift these constraints or allow them to be circumvented would enable further home building.

5.4.1 *Raising debt caps to prudential limits*

The government has imposed additional debt caps on the housing revenue account of local authorities, which limits their ability to borrow to fund investment in new affordable housing. These constraints are unique to housing and are in addition to local authorities' adoption of the 'prudential code' as set out by the Chartered Institute for Public Finance and Accountancy.

The removal of the additional debt cap on housing revenue accounts has been campaigned for vigorously by the National Federation of ALMOs, the Association of Retained Council Housing, the Chartered Institute for Housing and the Local Government Association.[58]

This would give equal treatment of housing with other areas of capital expenditure by local authorities – and permit higher borrowing for affordable homes. However, this isn't about giving councils free-reign to spend. They would still have to ensure that their housing activities are self-financing (i.e. that borrowing for housing can be funded through the rental income stream from tenants) and, under the prudential code, they could only borrow if they are able to do so 'sustainably'.

Of course, one of the reasons why councils have not been allowed to increase their borrowing caps is because the government is concerned with the levels of public sector net debt, and ALMOs and council housing services are classified as public corporations.

5.4.2 *Pooling or sharing housing revenue account headroom*

There is an uneven distribution of local authorities' headroom between their own debt caps and their individual levels of borrowing. If the aggregate headroom were redistributed, it may be possible to increase borrowing without breaching the overall ceiling.

[58] John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.

Authorities who have reached their borrowing cap but who wanted to invest more could use the headroom of councils who have borrowing capacity they do not wish to use. Alternatively authorities could combine their housing revenue operations. Although this would get round the problem of debt caps not having to be raised, there is currently only £2.8 billion of headroom across councils.[59] Sharing this headroom could create organisational difficulties as councils would have to bid to use it. Councils with headroom may also not want to share their headroom as they may be reserving it for future use.

5.4.3 Reform the status of ALMOs

Local authorities' arms-length management organisations are currently classified with public corporations in the national accounts, and are within the government's preferred measure of public sector debt.

Passing their ownership from local authorities to tenants would allow them to borrow more without impacting on the public sector balance sheet. Changing their constitution has been advocated by the National Federation of ALMOs and the Chartered Institute of Housing.[60]

5.4.4 Tax increment financing

Tax increment financing allows councils to borrow against future increases in local taxes resulting from property developments.

This mechanism for funding urban regeneration was pioneered in the United States, where it is used by municipal governments in nearly all states to stimulate economic development in targeted geographical areas. It uses anticipated increases in tax revenues to finance developments that are expected to generate those increased revenues. The supply of new or improved housing or infrastructure usually leads to both new development and an increase in the value of the surrounding property, which lead to greater levels of property, residential and business taxation in the area.

But local taxation works differently in the United States. In the United Kingdom, there is no direct link between property value and local tax receipts. Although new houses may lead to more households paying council tax, the potential tax revenues involved are not that large.

[59] John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.
[60] National Federation of ALMOs, *Building on the potential of ALMOs to invest in local communities* (National Federation of ALMOs, York), 2011.

5.5 Short listing policies

Although the various policies above all have their merits, we focus on a smaller group that we believe have the best chances for significant impact within the timeframe of the next parliament.

We have assessed the policies against the following set of criteria:

i. Would it lead to an increase in gross general government debt?

ii. Would it lead to an increase in public sector net debt?

iii. Does it have prior international evidence of success?

iv. Would it be quick to implement?

v. Would it have a material impact on the number of new affordable homes built each year?

Figure 32: Rationale for the short list of policies

	Does not increase gross general government debt	Does not increase public sector net debt	International evidence?	Quick to implement?	Material impact?
Reducing cost of funds					
Housing investment bank	✓		✓		✓
Livrét A style bank accounts	✓		✓		✓
Tax incentivised bonds	✓	✓	✓	✓	
Long dated index-linked debt	✓	✓		✓	
European Investment Bank funding	✓	✓	✓		
Loan guarantees for social housing	✓	✓	✓	✓	✓
Commercial terms for housing associations' debt					
Write off existing grant	✓	✓	✓		
Convert grant to equity	✓	✓			
Special purpose vehicles and real estate investment trusts	✓	✓	✓	✓	✓
Adverse credit rationing for small and medium sized enterprises					
Loan guarantees for small and medium sized enterprises	✓	✓		✓	✓
Local authorities' borrowing constraints					
Raising debt caps to prudential limits				✓	✓
Pooling or sharing housing revenue account headroom					
Reform status of ALMOs	✓	✓			✓
Tax increment financing			✓		

Source: Capital Economics

6 RECOMMENDED PACKAGE OF POLICIES

In this section, we develop our recommended package of policies. In particular, we explain in detail how the costs of funds can be lowered with a housing investment bank and *Livrét A* accounts system, a public guarantor can improve the commercial terms for housing associations and reduce adverse credit rationing for small and medium sized enterprises, and constraints on local authorities' borrowing can be eased by relaxing their borrowing limits, deploying local authority land and reclassifying the status of ALMOs.

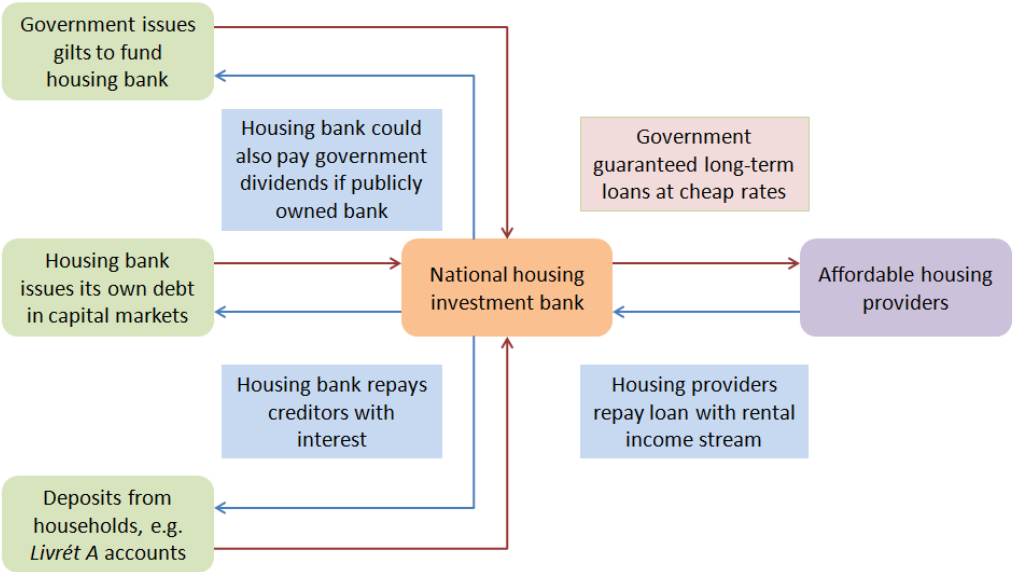
6.1 Reducing the cost of funds with a housing investment bank

A national housing investment bank could lead to reduced funding costs for affordable housing providers by making long-term low interest rate loans.

The purpose of a housing investment bank would be to make long-term loans, which are guaranteed by the government, at cheaper rates than affordable housing providers are currently able to access. The housing investment bank could access funding from several sources. First, the government could capitalise the bank directly after issuing gilts. Second, the housing investment bank could borrow directly from capital markets. Third, it could take deposits from households, possibly through a scheme similar to *Livrét A* accounts. (See Figure 33.)

If the funding source is from either of the latter two options, it is important that the government makes guarantees on the loans made out to affordable housing providers. The bank will need to have a credit rating as close to that of the government's as possible, so that it can lend to providers at the cheapest rates.

Figure 33: Illustrative example of the interaction between a housing investment bank and affordable housing providers



Source: Capital Economics

A form of a national housing bank already exists in the Netherlands with the *Bank Nederlandse Gemeenten*. Ownership of *Bank Nederlandse Gemeenten* is restricted to the Dutch public sector, the Dutch state's shareholding is 50 per cent with the remainder held by Dutch local authorities and one water board. The bank is a specialised lender to local and regional authorities as well as to public-sector institutions such as housing, utilities, and educational institutions. It is the largest public-sector lender in the Netherlands, and in this form it is similar to the public works loan board in the United Kingdom.

Although the *Bank Nederlandse Gemeenten* does not lend exclusively to housing associations, just over half of its lending is to this sector. At the end of 2012, the bank had €41.5 billion of long term lending outstanding to housing associations and during 2012 made €5 billion of new loans to them. This gave the bank a market share of 47 per cent in lending to housing associations. A national housing investment bank would therefore gain from economies of scale as it could become the largest lender for affordable housing. This would help to minimise the cost of its lending.

In addition, maintaining high creditworthiness permits the *Bank Nederlandse Gemeenten* to fund its operations at relatively low cost, and offers its public sector clients interest rates that are only slightly higher than its own cost of long-term funding. The long-term lending to social housing associations is guaranteed by *Waarborgfonds Sociale Woningbouw*, the social housing guarantee fund, and ultimately by the Dutch central government and municipalities. To obtain these guarantees, registered institutions have to fulfil certain conditions. The *Centraal Fonds Volkshuisvesting*, the central housing fund, is responsible for the financial supervision of the sector.

In 2012 the effective interest rate for the funding of *Bank Nederlandse Gemeenten* through debt securities was 1.7 per cent and the effective interest rate on lending the *Bank Nederlandse Gemeenten* extended was 3.6 per cent.[61] For 2012, the effective interest rate on borrowings by housing associations in the United Kingdom was 5.2 per cent.[62] Clearly if the housing associations had been able to borrow at rates similar to those extended on loans by *Bank Nederlandse Gemeenten*, the cost of funding would have been significantly reduced.

A housing investment bank could also be a revenue source for government. As it could be owned by the state, any distributed dividends would be returned to the Treasury. For example, the *Bank Nederlandse Gemeenten* has paid out €275 million in dividends in the period 2010-2012. Its current dividend policy is to distribute 25 per cent of net profit and expects this to apply up to 2018 until it has achieved the proposed BASEL III leverage ratio.[63] Alternatively these dividends could be recycled to invest in affordable housing. This shows that the profit a national housing investment bank makes could either be used to fund more affordable housing, pay down government debt or, more likely, a combination of the two.

The housing bank could be a new entity, part of the Green Investment Bank or part of the business bank that is currently being set up. The housing investment bank would require a mandate and a supervisory system to assess and monitor projects and ensure that lending was only for affordable housing. Some or all liabilities of the entity would have to be guaranteed by the government to ensure it retained the highest levels of credit worthiness and could deliver its goal of cheaper finance to affordable housing providers. If the bank funds itself through *Livrét A* type accounts, there will need to be an additional mechanism to transfer the funds from these accounts to the housing bank.

If a national housing investment bank was publicly owned and set up as a public corporation, the funding source does not matter for the definition of public sector net debt. Funding through household deposits would still count towards public sector net debt. If the bank was a not for profit entity that was not controlled by the government then funding through household deposits would not lead to an increase in public sector net debt. Furthermore, issuing

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[61] BNG Bank Base Prospectus 3 July 2013 available at http://www.bng.nl/DocsComb/Investors/Base%20Prospectus%20dated%203%20July%202013.pdf?agreecheck=on

[62] Homes and Communities Agency, *2012 Global Accounts of Housing Providers* (Homes and Communities Agency, London), 2013.

[63] BNG Bank Base Prospectus 3 July 2013 available at http://www.bng.nl/DocsComb/Investors/Base%20Prospectus%20dated%203%20July%202013.pdf?agreecheck=on

its own debt would not lead to an increase in public sector net debt. It would only be if the entity borrowed directly from the government, and the government funded this borrowing through additional gilt borrowing, that it would add to public sector net debt.

The guarantees made by the government on loans made out by the housing investment bank to providers of affordable housing would be contingent liabilities. These would not lead to an increase in public sector net debt unless the housing investment bank was unable to pay its creditors or the government takes such a large proportion of the risks that it is deemed to have control.

On a reasonable view, the housing investment bank has the potential to lower funding costs for housing associations by 100 basis points. The lower cost of funds would benefit housing associations at the expense of existing providers of finance to housing associations. Reducing the cost of finance by 100 basis points for housing associations would bring their borrowing costs to around the same level as local authorities.

6.2 Reducing the cost of funds with *Livrét A* accounts

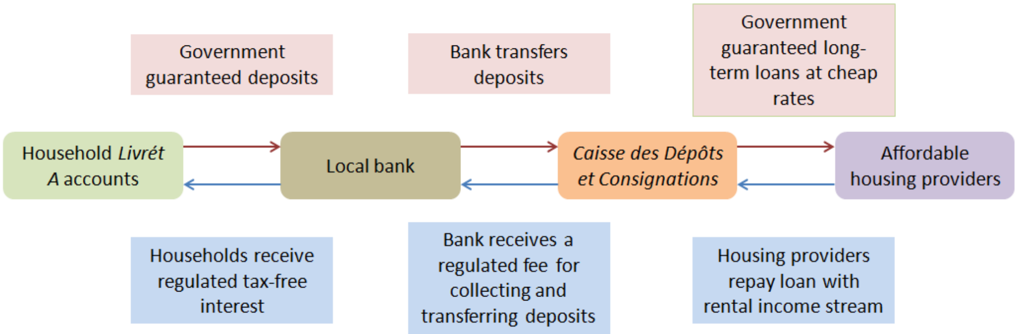
A system for funding loans to affordable housing providers, similar to the French *Livrét A* accounts, could lead to reduced funding costs for affordable housing providers. The policy would aggregate deposits from household held in special tax-free accounts and lend the funds out in the form of low cost long term loans to providers of affordable housing.

In France, households can make deposits into *Livrét A* type accounts held at local banks. Savers are allowed to open one *Livrét A* account at their local bank, into which they can deposit a maximum of €22,950. In return for making deposits households receive a rate of interest, set by the Ministry of Finance, that is tax free. The French central bank, *Banque de France*, recommends a rate of interest based on a formula that takes into account the rate of inflation and the funding costs of banks. The ministry of finance can choose to accept the recommendation or set a different rate.

The banks collecting the *Livrét A* deposits have to transfer up to 65 per cent to a central aggregator. Banks are not required to transfer all deposits so they can meet liquidity requirements. However, the remaining deposits that are not transferred can only be used to finance small and medium sized enterprises or energy savings works on old properties. The *Livrét A* deposits are passed onto a state-owned financial intermediary, the *Caisse des Dépôts et Consignations*. The banks receive a fee for collecting and transferring the deposits, set by the ministry of finance, which is currently 0.4 per cent. The *Caisse des Dépôts et*

Consignations converts the deposits into long-term low interest rate loans for affordable housing providers in France. The deposits made by households are guaranteed by the government and the loans made out the *Caisse des Dépôts et Consignations* are guaranteed by local authorities in around 95 per cent of cases, and by a mutual fund for the remainder.[64] (See Figure 34.)

Figure 34: Illustration of *Livrét A* accounts leading to the provision of affordable housing



Source: Capital Economics

Due to the tax-free nature of the accounts, the required rate of return for households is lower than other forms of investments. The decreased funding cost for the *Caisse des Dépôts et Consignations* therefore helps to reduce the cost of the loans that are then lent out to affordable housing providers. Government guarantees on the loans to housing providers further reduce the cost of funding for affordable housing providers. As all deposits are aggregated before being disbursed for a particular scheme, the system would also benefit from risk pooling. The combination of these factors enables the *Caisse des Dépôts et Consignations* to lend at a lower rate to housing associations than they are currently able to access, either in the capital markets or from banks. The scheme provides 70 per cent of social housing finance in France[65] and, in 2011, 120,000 units of social housing were financed out of the savings fund.[66]

The *Caisse des Dépôts et Consignations* holds responsibility for the distribution of funds, making sure that they are used for their intended purpose of funding affordable housing development, as well as assessing that the affordable housing schemes are viable and continuing to monitor the developments to ensure that the bank is paid back the money it lends out.

[64] Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.
[65] *ibid*
[66] See http://www.caissedesdepots.fr/fileadmin/PDF/presentation_institutionnelle/PresA4_CDC-GB-january2013.pdf

Households in the United Kingdom can already save in tax free individual savings accounts, but the funds raised in these accounts are not specifically earmarked for affordable housing development. There is significant appetite for a tax-free savings product though. During the financial year 2012/13 there were 14.6 million individual savings accounts with £221 billion of cash on deposit, and £57 billion was subscribed to adult individual savings accounts. In the five year period spanning 2008 and 2013, total cash savings increased by £78 billion.[67]

Assuming that there is no transfer of existing deposits, the flows would have to come as a share of the new savings each year in individual savings accounts. It may be that savers choose to save all or part of each new annual subscription allowance into an affordable housing individual savings account. Households may require incentives of higher interest rates though to reallocate their annual allowance to an affordable housing savings account. A survey by First Direct showed that 62 per cent of people had never changed individual savings account provider before in their life. [68]

In 2010-11, 31 per cent of individuals with individual savings accounts in the United Kingdom subscribed to the maximum of the annual allowance.[69] In France, when the maximum *Livrét A* and *Livrét de Développement Durable* allowances were raised by 25 per cent for each account in October 2012, there were a record €21.29 billion of deposits compared with just €0.39 billion in October 2011. This suggests that there would be significant household appetite in the United Kingdom to save more into tax free accounts, if they were allowed to do so.

A reasonable target would be for this policy to reduce the cost of funding for housing associations by 100 basis points. Currently, housing associations are able to borrow at an effective interest rate of five per cent. Existing individual savings accounts in the United Kingdom can act as a guide for the level of returns that households would need. As of January 2014, the effective interest rate on individual savings accounts was 2.12 per cent.[70] This leaves 188 basis points spare to remunerate banks for collecting and transferring the deposits, as well as to fund the lending operations of the central aggregator. Although banks in France are compensated with 40 basis points for *Livrét A* accounts, this is less than banks in the United Kingdom would be able to make if they were free to choose how they lent the deposits. For example, Barclays made a

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[67] HM Revenue and Customs, *Individual Savings Account (ISA) Statistics* (HM Revenue and Customs, London), September 2013.
[68] See http://www.comparethemarket.com/news/2013/march/62-have-never-switched-cash-isa-provider-first-direct-finds/
[69] HM Revenue and Customs, *Individual Savings Account (ISA) Statistics* (HM Revenue and Customs, London), September 2013.
[70] Bank of England data, BankStats Table G1.4.

margin of 89 basis points on deposits in its United Kingdom retail and business banking division for 2013.[71] We assume that the funding costs of the central aggregator would be similar to the margin of 80 basis points the public works loan board charges on lending to local authorities. Overall, we believe the margin on *Livrét A* style deposits would need to exceed 169 basis points to sufficiently remunerate all parties. This margin would create an indicative lending rate of 3.81 per cent. As such, we believe it reasonable to assume that a system of *Livrét A* style accounts would be able lend to housing associations at around four per cent, and deliver a 100 basis point reduction in their cost of funding.

In calculating the potential impact *Livrét A* accounts will provide, much will depend on the position of this savings account in a competitive market place. We are not convinced that such a product can have the same success in England as in France. However, it is not unreasonable to assume it could acquire a decent share of new business. For the sake of illustration, 25 per cent of new individual savings accounts' business is equal to £3.9 billion each year.

For this policy to work, government would have to set up an entity to act as the intermediary between the deposits collected by banks and lending them out to affordable housing providers. This institution would require a mandate and a supervisory system to assess and monitor projects and ensure that lending was only for affordable housing. The entity would also have to be guaranteed by the government to ensure it retains a high credit rating and could deliver its goal of cheaper finance to affordable housing providers. This newly created entity could be a national housing investment bank, or a similar aggregator. Whether or not this adds to public sector net debt depends on how the entity is created, and how it is controlled.

If the entity is a public corporation, the household deposits would count towards public sector net debt but not towards gross general government debt. If the entity is a not-for profit private company, these deposits would not count towards public sector net debt provided the government does not exercise control. The guarantees made by the government on these deposits and on the loans the entity makes would be classed as contingent liabilities. These will only count to public sector net debt if the government is required to make payments on behalf of the borrower to the entity or to repay household deposits.

[71] Barclays PLC, *Barclays PLC Results Announcement 2013* (Barclays PLC, London), 2013.

6.3 Relieving the commercial terms for housing associations with a public guarantor

Loan covenants often restrict housing associations from borrowing more. A public guarantor could reduce the cost of using special purpose vehicles, which raise debt off the balance sheet of housing associations, and make their use viable for the funding of affordable housing development.

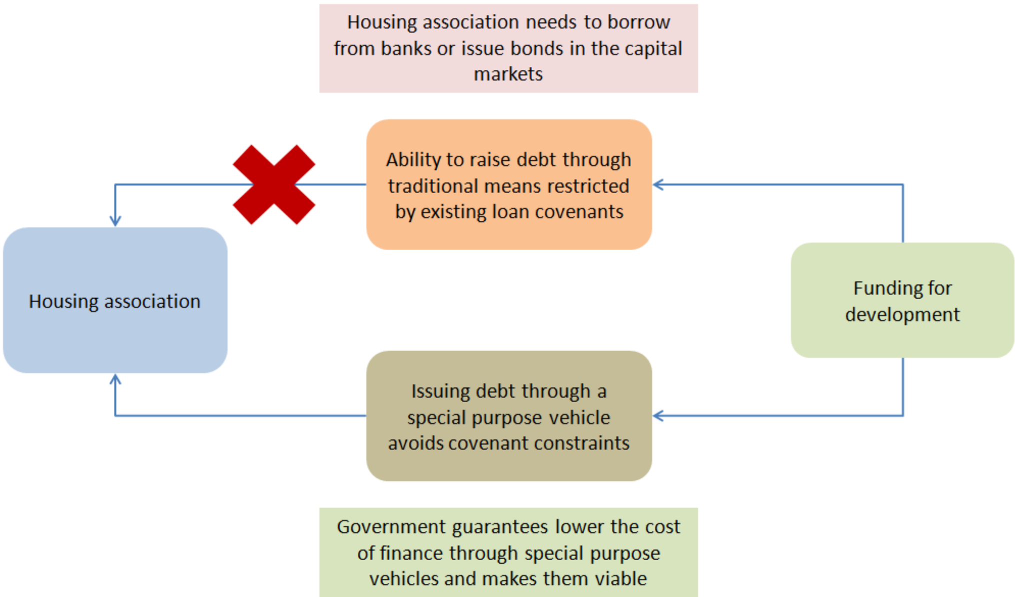
Housing associations have to borrow from banks or issue bonds in the capital markets to fund new affordable housing developments. Their ability to raise debt through these means is restricted by existing loan covenants. The covenants often limit how much debt the housing associations can hold relative to their grant and reserves. Housing associations can set up a special purpose vehicle to raise the debt, which has the advantage of being off the housing association's balance sheet.

Using a special purpose vehicle does not wholly get round the funding problem. Raising finance in this way is typically more expensive than traditional means. For example, the cost to the government of borrowing through private finance initiative schemes is quoted as being three to four percentage points above gilt rates.[72] It is more expensive as the debt is secured against the future rental income stream rather than the assets of the housing association. Typically though, the housing association would still have to contribute five to ten per cent of the value of the project, in the form of land or cash, to the special purpose vehicle as equity.[73]

A public guarantor could guarantee the debt of the housing association special purpose vehicle, thus reducing its cost of borrowing to a level that makes development schemes viable. (See Figure 35.)

[72] Balfour Beatty in written evidence to: The Treasury Committee, *Private Finance Initiative: Seventeenth Report of Session 2010-12* (The Stationary Office, London), 2011.
[73] Richard Parker, *Funding affordable housing – New options for housing associations?* (PricewaterhouseCoopers, London), 2008.

Figure 35: How guarantees can help housing associations



Source: Capital Economics

Guarantees are an advantageous way for the government to increase the number of affordable homes built each year without necessarily increasing the level of public sector net debt. Government guarantees on the debt of certain corporations allows them to borrow at a more beneficial interest rate, and in some cases allows borrowing where otherwise it would not happen. This is because the creditor is reassured that, if the debtor is unable to make full repayments, the guarantor will settle the liability. In general, the guaranteed debt is recorded exclusively as the borrowing of the corporation. For the government, it is a contingent liability. In the public accounts, the guaranteed debt will not usually be recorded in the core accounts until the guarantee is activated.[74] In the United Kingdom these contingent liabilities are reported to Parliament and recorded in the 'Whole of Government Accounts'.[75]

Guarantees made by the government on loans to housing associations through special purpose vehicles would not therefore lead to an increase in public sector net debt provided the scale of risk faced by the government is not judged to give it control. The guarantees would be contingent on the housing association being unable to meet the repayments due on the debt. Only when the housing association is unable to meet these dues would the government assume the debt and it lead to an increase in public sector net debt.

[74] For a full discussion see European Commission, *Manual on Government Deficit and Debt – Implementation of ESA95* (Publications Office of the European Union, Luxembourg), 2012.

[75] HM Treasury, *The whole of government accounts year ended 31 March 2012* (The Stationary Office, Norwich), 2013.

There is international evidence of the success of guarantees on the borrowings of affordable housing builders. Guarantees are part of the *Livrét A* scheme in France and also that of lending by the *Bank Nederlandse Gemeenten* in the Netherlands. In the Netherlands these guarantees are provided by the national social housing guarantee fund, *Waarborgfonds Sociale Woningbouw*. The guarantees are funded by fees from social landlords and are backed by central and local government. In the Netherlands these guarantees have been able to cover 80 per cent of loans to the housing sector, reducing interest rates by 1.0 to 1.5 percentage points.[76]

Guaranteeing loans can create moral hazard though. Moral hazard with regards to lending arises when the party making the loan would not suffer from losses if the borrower defaults. The purpose of the guarantees is to remove the potential risk of losses to the lender. However, to overcome moral hazard, guaranteeing the loans does not mean that the government would take all of the risk. There would have to be a risk sharing arrangement so that lenders aren't incentivised to just extend credit to any firm. In this form the government would share any loss with the lender, according to a pre-determined split.

Government guarantees are not new in the United Kingdom. For example, the government already guarantees the debt of Network Rail, a "not-for-dividend" private company limited by guarantee, while the export credits guarantee department guarantees against loss for or on behalf of exporters of goods and services and overseas investors from the United Kingdom.[77] The government also operates a mortgage guarantee scheme (under the Help to Buy Programme) and in this way acts as the guarantor for household mortgages. In the scheme, HM Treasury is the guarantor and directs UK Asset Resolution Limited Corporate Services[78] to run the administration of the scheme.[79] The government provides an effective fifteen per cent guarantee on the purchase price of the house, but out of this the lender is required to bear five per cent, thus reducing the maximum loss to the government of 14.25 per cent of the purchase price of the house. In this way the risks are shared.

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[76] Julie Lawson, Tony Gilmour and Vivienne Milligan, *International measures to channel investment towards affordable rental housing* (Australian Housing and Urban Research Institute, Melbourne), 2010.
[77] HM Treasury, *The whole of government accounts year ended 31 March 2012* (The Stationary Office, Norwich), 2013.
[78] UK Asset Resolution Limited Corporate Services is a subsidiary of UK Asset Resolution Limited, which is the holding company that brings together the government-owned businesses of Bradford & Bingley plc and Northern Rock (Asset Management) plc.
[79] http://www.ukarcsl.co.uk/about-ukar.aspx

Importantly, the government has recently launched a guarantee scheme for both new affordable homes and new homes for private rental. The affordable homes guarantee was announced in September 2012 as part of the 'Housing and Planning package'.[80] Under this enhanced scheme, the government has committed to provide guarantees for up to £3.5 billion of registered providers' debt and, in doing so, provide housing associations with access to potentially lower cost funds. Subject to demand this scheme could be boosted by a further £3 billion being held in reserve.[81]

There is much to applaud in the new scheme. It is broadly of the right scale but it is still too early to judge its likely performance, and especially whether it actually delivers guarantees up to the amount proposed. In particular, the scheme is focussed on a relatively short time frame, with government commitments contingent on building works being started within twelve months of drawdown and, if grant is required, start on site by 31 March 2015.[82] Pressing for quick delivery is clearly not bad in itself, but there is a danger if the scheme is too fast-paced to permit sensible projects to proceed. Moreover, it is unclear how long these new arrangements will last. The government has said that applications for the affordable housing guarantee must receive approval in principle from government by 31 March 2015, indicating that the scheme will end then.[83] The funding problems facing the sector are deep-seated; the policies to address them need to have permanence – and need to be seen to have permanence if they are to inspire the appropriate confidence in housing associations and investors. Meanwhile, the arrangements permit the government to guarantee only the debt of registered providers; this must not be allowed to restrict housing associations in their use of special purpose vehicles to mitigate covenant restrictions.

The aim of the policy should be to allow housing associations to fund affordable housing development projects without contravening loan covenants, by making the use of special purpose vehicles viable. The policy should have time horizons far beyond 2015 to ensure it can have the greatest impact possible.

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80 See: https://www.homesandcommunities.co.uk/ourwork/affordable-homes-guarantees-programme (accessed 07-03-14).

81 See: https://www.gov.uk/government/news/10-billion-housing-guarantees-open-for-business (accessed 07-03-14).

82 Department for Communities and Local Government, *Housing Guarantee Scheme Rules – Affordable Housing* (Department for Communities and Local Government, London), 2013. Department for Communities and Local Government, *Affordable Homes Guarantees Programme - Update to Framework published on 27 February 2013* (Department for Communities and Local Government, London), 2013.

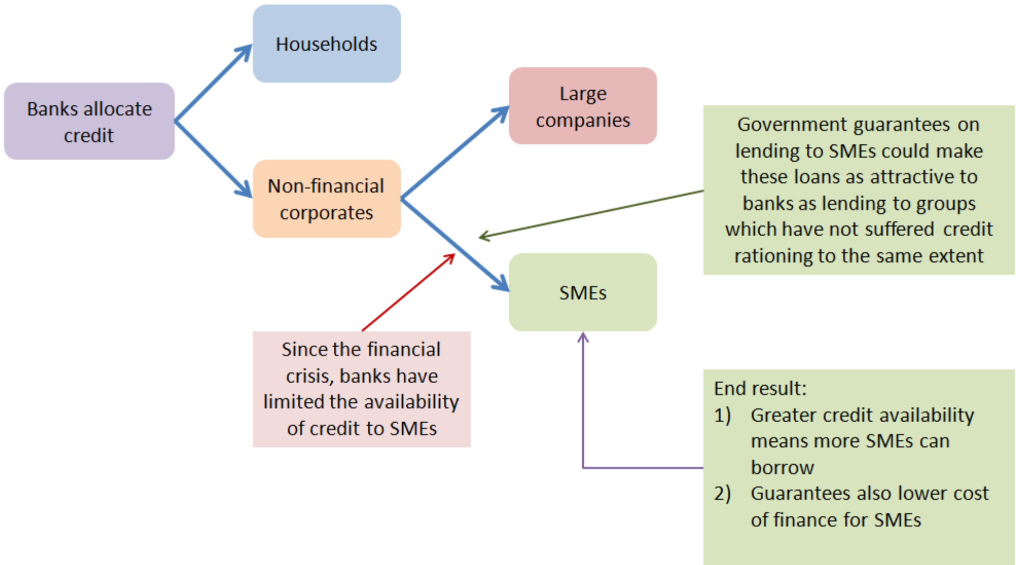
83 Department for Communities and Local Government, *Affordable Homes Guarantees Programme - Update to Framework published on 27 February 2013* (Department for Communities and Local Government, London), 2013.

6.4 Improving small and medium sized enterprises access to funds with a 'Help to Build' guarantor

A 'Help to Build' guarantor could allow many more small and medium sized enterprise developers to access credit and therefore build more houses.

Since the financial crisis banks have altered their credit allocation policies, resulting in a reduction in lending to non-financial corporates and in particular to small and medium sized enterprises. A 'Help to Build' guarantor could give many more small and medium sized enterprises access to bank credit by making them as attractive to banks as other larger businesses and households. Their increasing attractiveness to banks comes from the reduction in potential losses the bank would suffer if the borrower defaulted. The potential losses are made smaller by the guarantee because the guarantor covers some of the cost of the loss. (See Figure 36.)

Figure 36: Improving small and medium sized enterprises access to funds



Source: Capital Economics

The public guarantor would guarantee loans for small and medium sized enterprises, and it would be particularly helpful in the context of affordable housing if these guarantees were conditional on the funding being used for building affordable homes. Guaranteeing the loans could also significantly reduce the cost of loans to small and medium sized enterprises as the risk of lending is reduced, making even more development schemes viable.

Guaranteeing loans can create moral hazard though as discussed in more detail in section 6.3. Moral hazard regarding lending arises when the party making the loan would not suffer from losses if the borrower defaults. The purpose of the guarantees is to remove the potential risk of losses to the lender. However, to overcome moral hazard, guaranteeing the loans does not mean that the government would take all of the risk. There would have to be a risk sharing arrangement so that banks aren't incentivised to just extend credit to any firm. In this form the government would share any loss with the bank, according to a pre-determined split, and the risks would be shared.

Guarantees made by the government would not lead to an increase in public sector net debt, provided the scale of risk faced by the government is not judged to give it control. The guarantees would be contingent on the small and medium sized enterprise being unable to meet the repayments due on the debt. If the government is not deemed to be in control, only when the small and medium sized enterprise is unable to meet these dues does the government assume the debt and then public sector net debt would increase. The contingent liabilities are reported to Parliament and recorded in the 'Whole of Government Accounts', which is published by HM Treasury.

A public guarantor for small and medium sized enterprises would change the behaviour of banks and incentivise them to change their current allocation of credit to small and medium sized enterprises. Addressing the balance of credit allocation would enable small and medium sized enterprises to re-access the credit markets, therefore allowing a larger number of firms to borrow and therefore invest in affordable housing. Small and medium sized enterprises would also benefit from reduced cost of funding, bringing their costs closer to those of larger developers.

Returning credit allocation ratios to pre-recession levels would require banks to increase lending to small and medium sized enterprises by sixteen per cent. (See section 3.) We assume a sixteen per cent increase in lending to small and medium sized enterprises leads to a sixteen per cent increase in house building by small and medium sized developers. On current build rates this would lead to approximately 3,000 new homes each year at a cost of around £435 million. If this scheme were to leverage the guarantees at the same ratio as the government anticipates lending will increase under 'Help to Buy', the government would have to provide a minimum level of guarantees of £40 million to small and medium sized housing developers.[84] However, this could be higher if lenders require that the government guarantees a larger proportion of a new loan before they are willing to increase their lending to the small and medium sized developers.

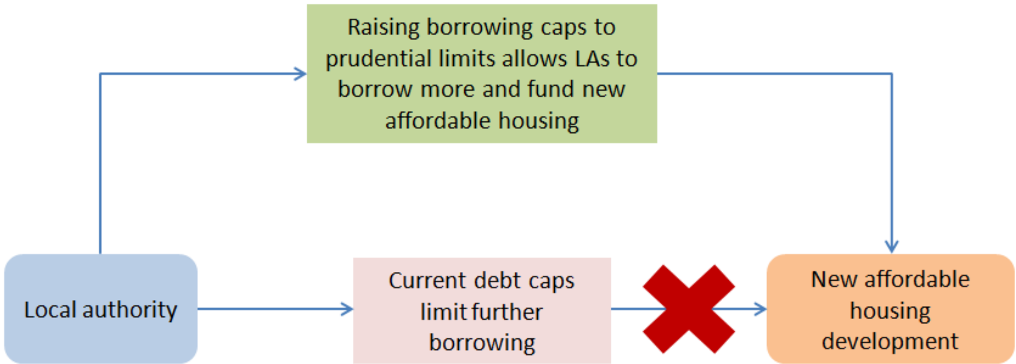
[84] For 'Help to Buy' the government anticipates £12 billion of guarantees will lead to an additional £130 billion of lending. See: HM Treasury, *Budget 2013* (The Stationary Office, Norwich), 2013.

6.5 Relaxing local authority borrowing limits

Local authorities are unable to borrow beyond their housing revenue account debt caps to fund affordable housing development. Removing these constraints would allow them to borrow according to prudential limits and therefore increase the supply of affordable housing.

Councils operate their housing under a self-financing regime, i.e. they are able to fund their borrowing for housing through the rental income stream of tenants. In addition, their prudential code states that councils should only borrow if they are able to do so sustainably. The current debt caps are set at a level that further restricts their borrowing. Raising debt caps to prudential limits would allow them to borrow more and therefore fund new affordable housing investment. (See Figure 37.)

Figure 37: Removing the constraints on LAs' borrowing



Source: Capital Economics

A report by the National Federation of ALMOs in 2012 estimated that if councils were able to use their full borrowing potential, but still under prudential rules, they would have the capacity to borrow up to £27 billion if they were to let new homes at affordable rents. The report stated that work by the Chartered Institute of Housing showed that in practice, if the caps were removed, councils would choose to borrow £7 billion over a five year period.[85]

One of the reasons why councils have not been allowed to increase their borrowing caps is because the government is concerned with the levels of public sector net debt. Arms length management organisations and council housing services are classified as public corporations, which falls under the definition of public sector net debt. If the United Kingdom followed standard international practice, these debts would not be considered as part of the targeted state debt measure.

[85] John Perry, *Let's get building* (National Federation of ALMOs, York), 2012.

A report by Capital Economics in 2012 found that the possible objections to extra borrowing were either not as great as claimed or that they could be resolved in time without prejudicing the market's trust in government accounts. Furthermore none of the City interviewees for the report thought that £7 billion of extra borrowing was sufficient for markets to get worried about, irrespective of the accounting methods used. So although there may need to be wider knowledge of different accounting methods to ensure market participants are fully aware of the context of the extra borrowing, in practice this is unlikely to be needed as the level of borrowing is immaterial.[86]

Relaxing local authorities' borrowing limits would put affordable housing on the same level playing field as other government priorities that are paid for by councils. Local authorities would gain the freedom to borrow up to around £20 billion more than current debt caps provide for. It would allow councils to borrow at the rate determined by the public works loan board.

If, despite the obvious benefits, government does not decide to relax local authorities' borrowing limits, it would still be possible for arms length management organisations to borrow more if they were able to re-establish themselves outside of government control.

A report by the National Federation of ALMOs suggested three models that would reclassify arms length management organisations as private, non-profit corporations. In each of these models two-thirds of the ownership is in the hands of tenants and independents. They involve: reducing the local authority's share in the ownership of the arms length management organisation and giving it a long-term management contract; a long-term management contract and transfer of some vacant properties or land; and transfer to a community-and -council-owned organisation. The report concluded that these models would be sustainable and enable "authorities to meet the investment needs in their housing stock", and that the community- and council-owned organisation model is "the one most likely to provide a solution to authorities which require borrowing significantly above the cap".[87]

Reforming the status of arms-length management organisations so they are classified as private not-for-profit corporations would enable them to access private finance without increasing public sector net debt. We believe that these newly reformed institutions would want to invest to the same extent as local authorities had they been able to increase borrowing to prudential limits.

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[86] Capital Economics, *Let's get building: The view from the City* (Capital Economics, London), 2012.

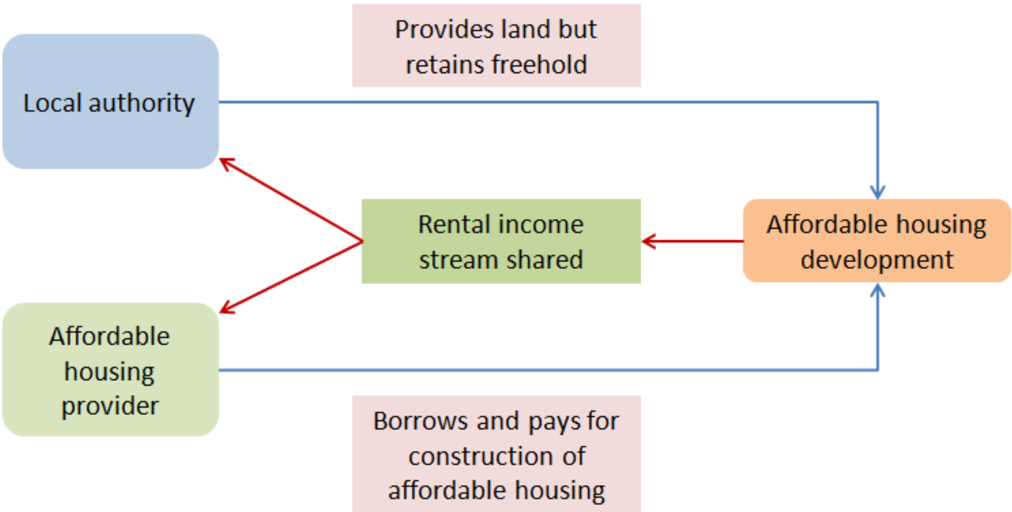
[87] Ian Doolittle, Steve Partridge, John Perry and Rachel Terry, *Building on the potential of ALMOs to invest in local communities* (The National Federation of ALMOs, York), 2011.

6.6 Deploying local authority land to avoid borrowing constraints

Local authorities could lease their land to affordable housing providers, whilst retaining the freehold. In this way local authorities don't need to borrow more and above their debt caps, whilst affordable housing providers avoid the often prohibitive upfront cost of land. This arrangement could deliver more affordable housing units.

The public sector holds 40 per cent of the land that is suitable for residential development.[88] Within that, local authorities own 51 per cent.[89] Local authorities are constrained in their ability to build on this land due to debt caps on their housing revenue account. Affordable housing providers can find the upfront cost of purchasing land prohibitive for the development of new housing. Local authorities could lease land to providers, thus circumventing both issues, and have an agreement on how the rental income from tenants should be shared. (See Figure 38.)

Figure 38: Illustrative public sector land model



Source: Capital Economics

The structure of this model has been used successfully in England already. The development of a mixed housing tenure scheme in the Royal Borough of Kensington and Chelsea was done in this way with Grainger Plc as the

[88] Department for Communities and Local Government, *Accelerating the release of public sector land: Update, overview and next steps* (Department for Communities and Local Government, London), 2011.
[89] Andy Hull, (Institute for Public Policy Research) in written evidence to: Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London), 2012.

developer. The major component of this development scheme will be rental accommodation, although this will mostly be for private rental. Nevertheless it offers a practical example of how this policy would work in the case of affordable housing. The homes will be managed by Grainger for a management fee under a 125 year agreement, whilst the council retains freehold ownership of the sites and shares a proportion of the long term rental income stream with Grainger. This model would therefore be well suited to the construction of properties for affordable rent.[90]

Leasing local authority land overcomes the significant land barrier cost for affordable housing developers. It also allows the local authority to retain the ownership of the land and ensure that it is always used for affordable housing. As this mechanism reduces the cost of development for housing associations, it should increase their take up of funds.

Another variant of this model has also has some success in England with the Birmingham Municipal Housing Trust.[91] The trust initially owns the plot of land for development and it remains under the ownership of the trust until after the sale of the home is completed. The land and property are transferred directly to the purchaser and the developer receives the sale receipt less the cost of the land. In this way homes can be constructed for affordable home ownership and the developer does not have the upfront cost of land as an obstacle.

By leasing the land to affordable housing developers, local authorities open themselves to the possibility of sharing the rental income from tenants. In the stylised model below, the local authority grants a lease to a housing association to construct affordable homes for rent on local authority land. The housing association shares some of the rental income stream with the local authority as lease payments. The rental share has been set so that the housing association could pay for all of construction through borrowing (i.e. the net present value of the income stream) without requiring grant or other funding. The model shows that the local authority could receive around fifteen to 31 per cent of the rent depending on location. In regions of high value land the net present value of the future income stream to the local authority is less than the value of the land. Although, in this case, the local authority would be making a subsidy to the housing association, this is in the form of the opportunity cost of not selling the land on the open market rather than a cash outflow. And, in areas of lower value land, the net present value of the future

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[90] See: http://www.londoncommunications.co.uk/2014/01/consent-for-graingers-build-to-rent-developments-in-rbkc/ (accessed 07-03-14).

[91] See: http://www.birmingham.gov.uk/cs/Satellite?c=Page&childpagename=SystemAdmin%2FCFPageLayout&cid=1223356833109&packedargs=website%3D4&pagename=BCC%2FCommon%2FWrapper%2FCFWrapper&rendermode=live (accessed 07-03-14).

rental income stream to the local authority is greater than the sale value of the land. (See Figure 39.)

Figure 39: Local authority rental share

	Outer London	East and South-East	Rest of England
Local authority: Unit land cost	£90,552	£56,202	£31,233
Housing association: Unit construction cost	£94,316	£82,764	£73,606
Rental share to local authority	31%	23%	15%
NPV rent to local authority	£47,577	£41,706	£37,108
Implied subsidy from LA to HA	£42,975	£14,497	-£5,875
NPV of rent to housing association	£94,364	£82,719	£73,601
Funding gap for housing association (NPV rent less construction cost)	£48	-£45	-£5

Source: Capital Economics

Local authorities are already allowed to implement a policy of this nature. The government could introduce targets for local authorities so that this policy is used more widely and its uptake is accelerated. One further potential barrier could be whether affordable housing providers are able to circumvent their own loan covenants so that they can borrow more to fund the construction costs.

Local authorities are constrained in their ability to finance new affordable housing, whilst developers face a constraint in the cost of land. A developer of affordable housing builds an asset that has lower accounting value than if it was built for the open market. However, they are faced with purchasing the land at open market rates. By leasing the land from local authorities they do not have to purchase it, thus overcoming the barrier. For local authorities it allows them to build affordable housing on their land without losing ownership of the land and it allows them to avoid their borrowing constraints. Private developers might lose out if they would have been able to purchase the land otherwise, whilst in some regions of England local authorities have the opportunity cost of the foregone sale which would provide a higher net present value than that of their share of the rental income stream.

6.7 Policy recommendations

It is time to see affordable housing investment as part of the macroeconomic solution. We have three main recommendations for the government to help boost affordable home building and support the macroeconomic recovery:

Recommendation 1:
Borrow to invest using the most cost-efficient sources of funds

There is no reason for the government to be shy of borrowing to invest – especially for affordable housing where the multiplier effects will be substantial and timely.

R1.1: Increase capital grants as quickly and as substantially as possible. Increasing capital grants for housing associations, which are funded out of general taxation and through gilts, is the simplest, quickest and cheapest method to deliver additional new affordable homes. On the current trajectory of its fiscal position, the government should invest an additional £3.6 billion per annum in grant funding over the life of the next parliament. Increasing the amount of grant available per unit would also ensure the development of homes for social rent and further stimulate housing supply.

R1.2: Permit local authorities to borrow to their prudential limits. The debt cap limits on local authorities' borrowing for new housing investment are arbitrary, distorting and counter-productive. Local authorities should be permitted to borrow for housing under the same conditions as their borrowing for other investment.

Recommendation 2:
Recognise the inconsistencies in public sector accounting and act to reduce their perverse effects

The targeting of the public sector net debt rather than other equally sensible measures by the government is disproportionately detrimental to affordable housing investment.

R2.1: Focus on general government rather than public sector debt. Although the government should not dispense with monitoring and targeting public sector net debt, it should place greater focus on the general government measure – and permit greater flexibility for public corporations to borrow. Provided there is transparency and the borrowing is for capacity-enhancing investment, capital market investors will not worry.

R2.2: Reconstitute councils' arms length management organisations (and similar local authorities' activities and organisations) as private not-for-profit organisations. As councils are required to operate their housing activities on the basis of self-sufficiency, there is little to be gained from keeping them within the public sector umbrella. Outside of government control, tenant-owned trusts or similar entities will be able to borrow without detriment to the public debt measures – although will need government guarantees to access cheaper finance.

Recommendation 3:
Establish fit-for-purpose institutions to deliver more and cheaper finance to housing associations and others in the affordable housing development chain

The structures and mechanisms to fund affordable housing investment could scarcely be more complicated or costly – and, critically, they make poor use the government's ability to leverage cheaper finance in capital markets.

R3.1: Ensure that the 'affordable homes guarantee programme' delivers on its promises. There is much to commend the newly announced scheme to underwrite housing associations' borrowing for new affordable homes, especially as an intermediate measure to a more comprehensive and cost-effective solution. However, this needs to be a programme (or the stepping stone to a programme) that has time horizons beyond 2015 to ensure that it provides confidence to the sector and its investors.

R3.2: Build and improve upon the 'Network Rail model' to establish a new funding platform. Constituted as not-for-dividend institutions which are not controlled by government, the platform can raise debt outside of public sector borrowing constraints – while obtaining cheap rates through guarantees partially backed by the Treasury. The platform should include:

R3.2(A): A housing investment bank focussed on providing finance to the housing association sector. A national housing investment bank should have the economies of scale and the specialised expertise to deliver cost effective loans to housing associations. With its liabilities partly guaranteed by the Treasury, it will be able to issue debt to the open market at favourable rates without detriment to the government's favoured public sector net debt measure.

R3.2(B): Special-purpose tax-free 'housing bonds' savings accounts to provide a cheap source of capital. The creation of a new form of tax-free individual savings account, which is marketed and distributed by existing retail banks for a commission, to provide additional low-cost funds for the housing investment bank.

R3.3: Extend the existing 'Help to Buy' scheme to include 'Help to Build'. The government is already providing partial guarantees for home purchases. Extended the scheme to assist small and medium sized construction and development firms wanting to build affordable homes will help unwind some of the adverse credit rationing that that sector has been facing since 2008.

R3.4: Deploy publicly owned land to improve the viability and bankability of projects. With land acquisition accounting for a large proportion of the development costs of new housing, the public sector can utilise its own portfolio of property with housing associations and developers to deliver housing schemes that require less up-front financial investment.

7 IMPACT OF IMPLEMENTING THE POLICY RECOMMENDATIONS

In this section, we consider the potential impact of implementing the policy recommendations on housing output, government borrowing and liabilities, and the wider macroeconomy. We also conduct sensitivity analysis and assess the likely time it will take before the full impact of the recommendations can be felt.

Our modelling assesses the recommendations through a series of impacts. Although we believe that the *Budget 2014* should have increased funding available for capital grants, our calculations are based on the assumption that there is no change to grant funding already outlined in the 2015-18 affordable homes programme, i.e. it is fixed. The number of homes that could be built for social rent if grant levels increased are not, therefore, taken into account. (See Figure 40.)

Figure 40: Models to assess the impact of policy recommendations

Recommendation	Impact assessed through
R1.1: Increase capital grants	Not examined
R1.2: Permit local authorities to borrow to their prudential limits	Local authorities borrow £7 billion more to invest in affordable housing
R2.1: Focus on general government rather than public sector net debt	Local authorities borrow £7 billion more to invest in affordable housing
R2.2: Reconstitute ALMOs as private not-for-profit organisations	Local authorities/ALMOs borrow £7 billion more to invest in affordable housing
R3.1: Ensure that the 'affordable homes guarantee programme' delivers on its promises	Impact of 100bp cut in HA cost of funds plus HAs build ten per cent more due to reduced borrowing constraints
R3.2: Build and improve on the 'Network Rail model' to establish a new funding platform	Impact of 100bp cut in HA cost of funds plus HAs build ten per cent more due to reduced borrowing constraints
R3.3: Extend the existing 'Help to Buy' scheme to include 'Help to Build'	SME guarantee scheme, which reduces funding costs by 100bp and increases lending to SMEs by sixteen per cent
R3.4: Deploy publicly owned land	Local authorities lease land to housing associations, who share the rental income stream with local authorities

Source: Capital Economics

7.1 Potential impact on housing output

Implementing the recommended package has the potential to deliver a material increase in affordable house-building, as well as making a modest contribution to the number of homes built for open market sale. The total potential impact is estimated at around 30,200 new homes each year, of which almost 25,600 would be affordable.

With the cost of land being one of the largest barriers to building more houses, it is no surprise that removing the upfront cost of land for housing associations and encouraging an existing land-owner (local authorities) to fund new development would have the greatest impacts overall. At current dwelling density rates for new developments, this would require approximately 159 hectares of public land for development each year.[92] (See Figure 41.)

Figure 41: Estimates of potential impact on housing output

Additional homes built per annum		Affordable	Open market	All
Impact of 100 bp cut in HA cost of funds				
S106 build		1,202	2,232	3,434
HA own build		3,943	-	3,943
Impact of SME guarantee scheme				
S106 build	100 bp cut in costs	216	401	616
S106 build	Credit rationing to pre-crisis ratios	1,064	1,976	3,040
Impact of loosening HA financing restrictions				
HA build		2,500	-	2,500
Impact of loosening LA financing restrictions				
LA build		9,800	-	9,800
Impact of public land availability model				
LA/HA JVs		6,839	-	6,839
Total		25,564	4,609	30,173

Source: Capital Economics' own calculations

Finance is not the only barrier to house-building though. Other obstacles that need to be overcome include the planning regime, land ownership, and the capacity of the construction sector. Work is being done by Shelter to estimate how improvements in these areas could lead to more homes being built.[93] We are unable to comment on how reducing the financing barriers will interact with the removal of these other problems.

Nevertheless, to illustrate what could happen we consider a reformed house-building environment that could deliver build rates similar to those in the 1970s. In the 1970s overall completion rates in England were 84 per cent higher than the average from 2003-2012.[94] Estimated total output from the policy package would increase from around 30,200 a year to just over 45,000, on this higher level of base output. (See Figure 42.)

[92] Calculated using a density of 43 new dwellings per hectare. Source: Department for Communities and Local Government, Table P231, Land use change: density of new dwellings built, England.
[93] Shelter and KPMG, *Building homes for the next generation* (Shelter and KPMG, London), 2014.
[94] Source: DataStream.

Figure 42: Estimates of potential impact on housing output at 1970s completion rates

Additional homes built per annum in a 1970s type environment	Affordable	Open market	All
Impact of 100 bp cut in HA cost of funds			
S106 build	2,205	4,095	6,301
HA own build	7,236	-	7,236
Impact of SME guarantee scheme			
S106 build through 100bp cut in costs	396	735	1,131
S106 build through credit rationing returning to pre-crisis ratios	1,952	3,626	5,578
Impact of loosening HA financing restrictions			
HA build	2,500	-	2,500
Impact of loosening LA financing restrictions			
LA build	9,800	-	9,800
Impact of public land availability model			
LA/HA JVs	12,549	-	12,549
Total	36,638	8,456	45,094

Source: Capital Economics' own calculations

In our calculations we have split England into three illustrative regions: outer London; east and south-east of England; and the rest of England. Although these groups are not identical in land area or population sizes, the development costs of a unit of housing are significantly different such that this classification makes sense. Indeed our earlier calculations suggest that the cost of building one unit of affordable housing ranges from £105,000 in the rest of England, £139,000 in the east and south-east, and £185,000 in outer London. The rents that can be charged in each of these groups also differ. As such, the impacts of individual policies will vary between the geographies.

Although the total figures are broadly similar (9,643 new homes per annum in outer London, 10,189 in east and south-east England, and 10,340 in the rest of England) there is material differentiation across the policies. For example, there is almost double the effect of cutting the cost of funds for housing associations in the rest of England as compared with outer London. Furthermore, the public land availability model has the greatest impact in outer London, with 3,151 new affordable homes each year, compared with 2,351 in east and south-east England, and 1,338 in the rest of England. It is the cost of land that drives this difference. In outer London land is 49 per cent of a unit's development cost, it is 40 per cent in the east and south-east and just 30 per cent in the rest of England. (See Figure 43.)

Figure 43: Estimates of potential impact on housing output by region

Additional completed housing units per annum	Today's values			1970s values		
	Affordable	Open market	All	Affordable	Open market	All
Impact of 100 bp cut in HA cost of funds						
Outer London	1,348	388	1,736	2,473	713	3,186
East and South-East England	1,681	570	2,251	3,084	1,046	4,130
Rest of England	2,116	1,273	3,390	3,883	2,337	6,220
Impact of SME guarantee scheme						
Outer London	360	669	1,030	661	1,228	1,890
East and South-East England	435	809	1,244	799	1,484	2,283
Rest of England	484	899	1,383	888	1,649	2,537
Impact of loosening HA financing restrictions						
Outer London	757	-	757	757	-	757
East and South-East England	883	-	883	883	-	883
Rest of England	860	-	860	860	-	860
Impact of loosening LA financing restrictions						
Outer London	2,969	-	2,969	2,969	-	2,969
East and South-East England	3,460	-	3,460	3,460	-	3,460
Rest of England	3,371	-	3,371	3,371	-	3,371
Impact of public land availability model						
Outer London	3,151	-	3,151	5,781	-	5,781
East and South-East England	2,351	-	2,351	4,314	-	4,314
Rest of England	1,338	-	1,338	2,454	-	2,454
Total						
Outer London	8,585	1,058	9,643	12,642	1,941	14,583
East and South-East England	8,810	1,379	10,189	12,540	2,530	15,070
Rest of England	8,168	2,172	10,340	11,456	3,986	15,442

Source: Capital Economics' own calculations

We have to recognise that existing government policies may deliver some of the additional output that we have calculated, even if they haven't already. For example, the government's 'affordable homes guarantee programme' would encompass the 2,500 homes each year that we estimate as the impact of loosening housing association financing restrictions. Nevertheless, for this additional output to be built beyond 2015/16, this programme will have to be extended to be a permanent policy.

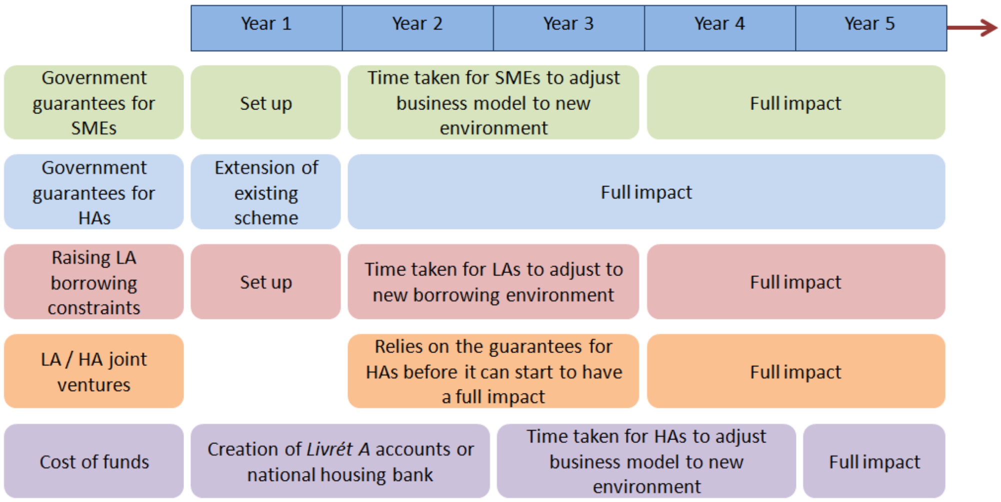
It would not be possible to achieve the total estimated impact from the first day the package of policies was implemented. It will take time to set up the mechanisms that enable each policy to function. As an example of how long it takes for announced policies to take effect, it was announced in September 2012 that a business bank would be created, with some of the functions expected to be operational by spring 2013 and full operations by autumn 2014.[95] This window of six months to two years can be taken as approximate for the time it would take to create many of the policies here.

The creation of the guarantees programme for housing associations and small and medium sized enterprises, and raising local authorities borrowing constraints could happen within the first year. However, it is slightly more complicated to set up the housing bank or *Livrét A* accounts. On a relatively conservative view it could take up to two years to create these institutions. Furthermore, to maximise the benefits of the local authority land sharing model, there may need to be an extension of the government's 'affordable

[95] HM Treasury, *Autumn Statement 2012* (The Stationary Office, Norwich), 2012.

homes guarantee programme' before housing associations are able to take on more debt. Moreover it could take up to two years for small and medium sized enterprises, households and local authorities to adapt their finances or business model to the policies once they are completely set up. (See Figure 44.)

Figure 44: Illustrative policy implementation timings



Source: Capital Economics

7.2 Potential impact on government borrowing and liabilities

The accounting treatment of any debt that is taken on or liability is critical to the success of any recommended policies. We have reviewed our package to understand and quantify its potential impact on the various key metrics that the Treasury are concerned with. Although somewhat dependent on how the policies are implemented, in some way or another there may be an increase in public sector net debt or contingent liabilities on behalf of the government. (See Figure 45.)

Figure 45: Potential impact on government borrowing and liabilities

Policy	Increase in general government debt?	Increase in public sector debt?	Generates public sector contingent liabilities?
Special-purpose tax-free 'housing bonds' savings accounts	No	Not necessarily	Yes
National housing investment bank	No	Not necessarily	Yes
Guarantees for housing associations	No	No	Yes
Guarantees for small and medium sized enterprises	No	No	Yes
Relaxing local authority borrowing constraints	No	Yes	No
Deploying publicly owned land	No	No	Not necessarily

Source: Capital Economics

7.3 Sensitivities and dependencies

The estimates of output that could be achieved so far rest on the premise that the entire policy package is delivered, which of course may not be the case. The potentially most contentious area is that some policies require an increase in the level of public sector net debt. There may not be the appetite within government to allow such an increase as it goes against government targets.

Funding more affordable housing without an increase in public sector net debt requires housing associations or the private sector to develop the units. The best way to achieve this is with government guarantees, otherwise housing associations will not be able to get past their own borrowing constraints with the use of special purpose vehicles and small and medium sized enterprises will not have access to credit. If this is the only government intervention, rather than permitting local authorities to borrow more to build affordable housing, the number of new houses built for all tenures will drop from almost 30,000 to 20,000 each year. Figure 46 below shows the interdependencies of the policies within the proposed package.

Figure 46: The interdependencies of the policies in the recommended package

Objective	Dependencies
Lowering cost of funds	• Requires housing associations to increase borrowing for full impact
Improving commercial terms for HAs	• Needed for any policy that increases housing associations' build rate through borrowing more • Could require government guarantees
Reducing adverse credit rationing for SMEs	• Could require government guarantees, but is independent of the other policies
Easing local authority borrowing constraints	• If local authority borrowing caps are not raised, then the land sharing model is the only policy that circumvents the constraints • The land share model though requires housing associations to borrow more

Source: Capital Economics

7.4 Macroeconomic impact on jobs and prosperity

If implemented fully, the policy package suggests that up to 30,000 additional new homes would be built each year in England at a cost of £4.3 billion. This investment will support new jobs as well as having a wider impact on economic activity. Research by L.E.K Consulting suggests that for every pound spent on construction output, it generates £2.84 of total economic activity or increase in gross domestic product, and provide up to 56 pence of total tax and benefits savings to HM Treasury.[96]

Using the annual spend of £4.3 billion, and the multiplier of 2.84, gross domestic product would increase by £12.8 billion each year or 0.8 percentage points of gross domestic product for the United Kingdom in 2012. There would be an annual £2.4 billion of total tax and benefits savings to HM Treasury.

Housing construction activity was responsible for 335,000 direct jobs in the United Kingdom in 2011.[97] Completions in England were responsible for 80 per cent of the share of the total number of completions in United Kingdom in 2011. The package estimates a total increase of 26 per cent per annum over completion rates in England in 2011. Applying the increase in England's housing output to its proportional share of housing activity jobs suggests an almost 71,000 additional jobs would be supported in the housing construction industry alone.

[96] L.E.K. Consulting, *Construction in the UK Economy: The Benefits of Investment* (The UK Contractors Group, London), 2009.
[97] Confederation of British Industry, *Unfreezing the housing market* (Confederation of British Industry, London), 2011.

APPENDIX

Figure 47: Calculating base scenario net present value of housing association rental income stream by geography

	Outer London	East and South-East	Rest of England
Net annual rent	£7,703	£5,994	£4,835
Annual maintenance fee (five per cent)	£385	£300	£242
Housing association annual net rental income	£7,318	£5,695	£4,593
Inflation	2.0%	2.0%	2.0%
Rental uplift above inflation rate for first ten years	1.0%	1.0%	1.0%
Gilt rate	3.3%	3.3%	3.3%
Housing association borrowing spread to gilts	1.7%	1.7%	1.7%
Nominal discount rate	5.0%	5.0%	5.0%
Real discount rate	2.9%	2.9%	2.9%
Discounting time period	25 years	25 years	25 years
Net present value of rental income stream	£137,157	£106,734	£86,083

Source: Capital Economics calculations. Note: annual rental figures are from Table 74c in the UK Housing Review 2013, available at http://www.york.ac.uk/res/ukhr/ukhr13/compendium.htm

Figure 48: Development cost funding sources

Funding source	Assumption for all geographies
Debt borrowing	Restricted to 90 per cent of the net present value of rental income stream
Grant funding	14 per cent of total development cost
Funding gap	Total development cost less debt borrowing and grant funding

Source: Capital Economics

Figure 49: Calculation of net present value of housing association selling newly built home in the future

	Outer London	East and South-East	Rest of England
Net present value of rental income stream	£137,157	£106,734	£86,083
Real appreciation	0.0%	0.0%	0.0%
Discounting time period	50 years	50 years	50 years
Real discount rate	2.9%	2.9%	2.9%
Net present value of future asset sale	£32,193	£25,052	£20,205

Source: Capital Economics

Figure 50: Base assumptions for developments by SMEs under section 106

	Outer London	East and South-East	Rest of England
Affordable housing unit sale value	£123,441	£96,061	£77,474
Open market unit sale value	£295,235	£260,650	£184,309
Discounting time period	2 years	2 years	2 years
Spread to gilts	2.2%	2.2%	2.2%
Inflation	2.0%	2.0%	2.0%
Nominal interest rate	5.5%	5.5%	5.5%
Real discount rate	3.4%	3.4%	3.4%
Open market unit sale net present value	£266,815	£235,560	£166,568
Section 106 affordable housing share	35 per cent	35 per cent	35 per cent
Weighted average development unit sale value	£216,634	£186,735	£135,385

Source: Capital Economics calculations.

Figure 51: Base assumptions for developments by private developers under section 106

	Outer London	East and South-East	Rest of England
Affordable housing unit sale value	£123,441	£96,061	£77,474
Open market unit sale value	£295,235	£260,650	£184,309
Discounting time period	2 years	2 years	2 years
Spread to gilts	1.2%	1.2%	1.2%
Inflation	2.0%	2.0%	2.0%
Nominal interest rate	4.5%	4.5%	4.5%
Real discount rate	2.4%	2.4%	2.4%
Open market unit sale net present value	£274,785	£242,596	£171,543
Section 106 affordable housing share	35 per cent	35 per cent	35 per cent
Weighted average development unit sale value	£184,868	£138,966	£135,385

Source: Capital Economics calculations.

Figure 52: How the reduction in housing associations' cost of funds leads to additional development

Impact of 100bp cut in housing associations' cost of funds on:	How the cut in cost of funds leads to additional development
Developments by housing associations	• Cut in cost of funds increases the net present value to housing associations of the future rental income stream • For the same amount of total borrowing, and assuming no additional grant used, housing associations can build more due to lower financing costs • Percentage change in output calculated as (change in net present value / total unit cost) • Percentage increase in output applied to 2005-13 average build rates
Section 106 developments by private developers	• The increase in net present value to housing associations of the future rental income stream means they can pay more for an affordable home built under section 106 • This then increases the unit profit for private developers and incentivises them to build more • Using an elasticity with respect to profit of 0.165 (Capital Economics' calculations), and applied to 2005-13 average build rates by private enterprises, gives additional output by private developers • Assume 35 per cent of this additional output is for affordable housing

Source: Capital Economics

Figure 53: How the SME guarantee scheme leads to additional development

Impact of SME guarantee scheme through:	How the SME guarantee scheme leads to additional development
Additional section 106 developments after 100 basis points cut in cost of funds for small and medium sized enterprises	• Assuming a two year construction period, lowering the cost of funds for small and medium sized enterprises increases the net present value of the achieved sale price of developments • This leads to increased profit per unit • Applying an elasticity of supply with respect to profit of 0.165 (Capital Economics' own calculations) to the change in unit profit gives an increase in output • Percentage increase in output then applied to current build rates to calculate additional units per annum • Assume that 35 per cent of new developments are affordable housing
Additional section 106 developments after credit rationing returns to pre-crisis ratios	• Returning credit rationing to pre-crisis levels would allow small and medium sized enterprises to borrow sixteen per cent more • Assume a sixteen per cent increase in borrowing leads to a sixteen per cent increase in output by small and medium sized enterprises • This is applied to current build rates and 35 per cent of these new units are assumed to be affordable homes

Source: Capital Economics

Figure 54: How the local authority/housing association joint venture scheme leads to additional development

How a local authority/housing association joint venture leads to the development of additional affordable housing
• Local authority owns the land to be developed and grants a lease to a housing association • Assume the housing association pays for the construction of the property and then makes an annual lease payment to the local authority once the property has been let out • The housing association can borrow to fund construction based on the net present value of the future rental income stream • The housing association can share a maximum percentage of the future rental income stream with the local authority as a lease payment, such that the net present value of the remaining income stream is equal to the cost of constructing the property • For the same amount of existing planned borrowing, housing associations can therefore build more homes as the cost of construction are reduced and no grant is required for these additional properties • This percentage increase in output is applied to recent build rates (2005-13 average) to give additional units per annum

Source: Capital Economics

Figure 55: Housing associations building homes for social rent with increased grant

Increase in homes built by housing associations if half of new homes were built for social rent with higher grant
• Recommended package of policies indicates housing associations would build an additional 6,443 homes for affordable rent each year • If, instead, half of these were built for affordable rent with no additional grant, and half were built for social rent with additional grant, housing associations would be able to build an additional 937 homes for social rent each year above the 6,443 total • The total additional homes built each year would increase to 7,381 new homes per annum • This is calculated as 3,222 homes for affordable rent and 4,159 homes for social rent • The homes at social rent assume grant of 39 per cent of total development cost (land and construction) • At a unit cost of approximately £143,000 on average, this would require £232 million in grant funding each year

Source: Capital Economics

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