Cambridge Centre
for Housing &
Planning Research

Opportunities for institutional investment in affordable housing

Report to the HCA Housing Finance Group 2011 prepared by:

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UNIVERSITY OF CAMBRIDGE

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Introduction

1. Given the context of the imbalance of housing supply and demand and the recent reductions and restrictions in public expenditure the search for new ways of raising finance to support the development of affordable housing has become a vitally important task.

2. The Housing Finance Group (HFG) was set up in 2009 by the then Chief Executive of the Homes and Communities Agency (HCA) Sir Bob Kerslake. He brought together a small group of experts who together would consider the issues and offer possible solutions (details of terms of reference of the group and its membership are given in Appendix 1). In brief its primary purpose was to consider ways of enhancing development of affordable housing by exploring access to private finance and funding improvements for the existing stock. Nigel Hugill, former Executive Chairman of Lend Lease Europe was appointed as Chairman of the group with Peter Williams, Director of the Cambridge Centre for Housing and Planning Research succeeding him in late 2010.

3. In 2010 the HFG published its first report (HCA, 2010) with a broad overview of the market context. Members David Montague and Richard Parker also produced a report on the housing association sector (PwC, 2010). As part of its on-going programme the HFG agreed, in April 2010, to establish a work-stream to consider the drivers for and benefits of encouraging institutional, as distinct from bank, investment in the UK's affordable housing stock.

4. This paper sets out the findings from that work stream setting out where institutional investment is already taking place, and where scope is seen for further investment. The paper concludes with a series of suggestions for future development. It should be made clear that the report offers the views of the work stream rather than those of the individuals involved in the HFG and the organisations they represent and self evidently it does not represent the views of Government.

5. For the purposes of this paper, the affordable housing stock is defined as that which is provided through registered providers (RPs–both public and private) and grant assisted in some way and is thus more affordable than open market housing. It includes the following categories of housing:

   - Housing Association and Local Authority social rented stock
   - Shared Ownership housing part owned by housing associations
   - Shared equity loans, from HCA and/or housebuilders
   - Intermediate rental housing provided by public and private bodies

6. By institutions we mean primarily UK Pension Funds and Life Companies. However, other private sector investors interested in investment in public stock might include overseas Sovereign Wealth and Pension Funds, and Opportunity Funds, representing bodies of individual or corporate investors. The global investment markets have the cash and potential interest to invest in this sector. They will therefore also fall within the scope of this paper as will retail distributed investment funds including REITs.

7. Investment is likely to be by means of debt or equity instrument, but there are also opportunities for the acquisition or refinance of asset portfolios currently in public ownership. We recognise that some institutions currently already investing in the affordable housing sector through the purchase of bonds issued by housing associations. Our aim here is to explore ways we can ensure increased investment rather than simply shifting from one type of investment to another.

8. In our view affordable housing should represent a low risk profile for a potential investor, something closer to secured senior debt rather than conventional property

market risk. It provides good liability matching characteristics for UK pension /life funds, with an index-linked return over a 25-year or longer period. This return is underpinned by government regulation along with grant and revenue streams as well as a significant asset base and strong occupier demand.

9. Little wonder then that around £70 billion of private finance has been raised by housing associations alone in the UK since 1988 and with no credit losses for funders. The sector has produced steady and safe if not spectacular returns to its funders (Whitehead and Williams, 2009), reflecting the secure risk profile although back-books are currently less profitable reflecting movement in the banks' cost of funds in recent years.

10. Prior to the CSR 2010, the TSA had estimated that the housing association sector alone has an annual funding requirement in excess of £5 billion. In our view we need to expand institutional funding and recent cutbacks in funding for affordable housing and the move to a new 'Affordable Rent' regime based on higher rents and reduced grant make this ever more pressing. We are encouraged by the clear evidence that the market is seeking to respond to the situation with a number of reports emerging in recent months which seek to explore ways of boosting funding for affordable housing. These include the Policy Exchange (2010), E.C.Harris (2010), Beever and Struthers (2010), Resolution Foundation (2011), and we make reference to this work later in the paper.

11. The paper is structured into 2 main sections. We begin with a discussion of Debt finance including project level investment and then move on to consider equity finance before closing with a short conclusion.

Debt finance

12. Debt finance has been at the core of private funding for the affordable housing sector in the UK and for modestly geared housing associations, conventional corporate debt will remain the most cost effective form of funding. However, there is a potentially finite limit to gearing capacity, particularly for fast growing associations whose capacity to invest will be restricted by the early years cash shortfall between their current income and fixed rate debt taken on to fund new development.

13. In particular for those RPs who sign up to the new Affordable Rent model, (which could ease interest cover constraints in higher value areas) balance sheet gearing covenants are expected to come increasingly into play. Whilst unlikely to be regarded as solvency threatening, RPs will wish to avoid renegotiating covenants with banks, who may seek to capitalise on opportunities to reprice.

14. There are divergent views as to the cost and continued availability of long term debt finance. Clearly with continued funding shortages and Bank regulation encouraging matching of term assets and liabilities, many bank debt funders are taking the view that they will move towards shorter to medium term finance (5 to 7 years), in the absence of any ability to reprice at say 5 years. However this has not become the norm, due to competition, so it remains a question as to whether long term bank debt will continue to be available. Some lenders have suggested it will but at a price as the capital cost of long term debt increases bank pricing above that of bonds. These recent moves may signal a shift towards a tiered market with banks providing short term (up to 5 years) finance, with the institutional market providing long dated debt. LSVTs have less ability to absorb refinancing or repricing risk and they are expected to be given priority for any longer term debt available.

15. In addition, given the changes being ushered in by the Housing Revenue Account reorganisation we may see the launch of a number of smaller RPs, whose funding will be assessed on a project rather than corporate basis.

16. The new affordable regime will reduce the differential between open market and affordable risk profiles, for established RPs there is unlikely to be any immediate change in credit assessment, but on a project basis, funders will need to establish funding criteria.

Conventional Bond finance

17. Bond finance, whether publicly listed or as a private placement, is already well established within the housing association sector. To illustrate this point we note the following;

- Current bond outstanding £7.6bn (Jan 2011*)*
- £2.26bn of debt raised since 2009
- Issued by individual HAs (limited to top 50 RPs) or collectively, through THFC/others in 2010 exceeding issuance in 2009 of £816m:
  - L & Q £300m Bond @ 1.15% above Gilts (1/2010)
  - THFC £72m Bond Tap @ 1.05% above Gilts – 5 HAs participated (3/2010)
  - Hyde Housing Association £200m @ 1.05% above Gilts (7/2010)
  - Notting Hill Housing Trust £180m @ 1.10% above Gilts (7/2010)
  - Sanctuary HG £120m Bond Tap @1.00% above Gilts (10/2010)
  - Circle Anglia £124m 2038 Sterling Eurobond issue @1.10% above Gilts (17/11/2010)
  - THFC £76.6m Bond TAP @ 0.99% spread. All in cost 5.40%. 8 RPs participated. (14/11/10)
  - Places for People $75m Private Placement 5 yr unsecured FRN (21/1/11)

18. There appears to be good institutional appetite for Bond Finance – possibly up to £30bn from the current investor base. Bond investor awareness of the sector is at a high level and the ability of the sector to withstand the credit shocks of the last 2 years has enhanced its credit standing. Traditional investors are UK insurance companies such as Aviva, L & G, M & G, Canada Life and Standard Life, either on own account or for funds with no significant interest from international investors in sterling market, but potential interest, with appropriate education into the sector.

19. The private placement market provides for smaller issues to be placed with individual investors, repayable on bullet basis at the end of a fixed lifetime – generally maximum 30 years. This is principally an issuer preference. They are fixed interest rate – Sterling bonds usually priced at a margin over a comparable Gilt, secured on affordable housing assets or very occasionally unsecured.

20. Issuers using conduits (such as THFC) will not require formal ratings. Moody's currently rates ten housing associations in the UK, whose ratings span from Aa2 to A1 with stable outlooks. They are tradeable although in reality there is limited liquidity in this market and most investors buy the bonds to hold. Private placements are less liquid but can be on sold by an investor.

21. Modified Spens clause leads to a cost to the borrower on early termination and therefore less flexibility than traditional Bank debt**.** A bank loan can be repaid at the option of the borrower without penalty, with the exception of a possible modest fee in the early years (and any swap unwinds cost). However a formal repayment of a bond requires payment of the present value of a portion of the margin over gilt for the remaining term. However in practice many borrowers may mitigate this cost through open market purchases or offering to provide an alternative instrument. Currently bond pricing is attractive relative to Bank debt finance. Major issuers are listed at 1% over gilt (1.20% over LIBOR if swapped out).

22. The Housing Finance Corporation (THFC) was founded in 1987 through a joint initiative of the Housing Corporation and the National Housing Federation. It is a non profit aggregating funder for the housing association sector. Its approach allows

smaller housing associations (now known as registered providers – RPs) to access the institutional bond market through the aggregation of individual debt requirements so that they reach a quantum that is acceptable to the institutional market. This is a concept which is replicable and in 2010 G B Social Housing and Traderisks also announced the launch of platforms allowing mid sized RPs to issue. This reflects growing institutional interest in the affordable housing market, and shortening of tenors in the banking market.

23. Further innovation has recently been seen through Places for People Housing Group undertaking a private placement which involves a Yen swap structure. The £76.2m, 30 year deal was funded by Japanese investors under the US insurer AFLAC. The issue is unsecured, but requires a 'negative pledge' covenant that the total value of unsecured properties held by the group remains above 1.1 times the value of the total unsecured debt. There was a 20/25bp premium for the unsecured nature of the deal. The investor paid the principal amount in yen, which was then swapped into sterling. This move signals a widening of the investor base for the sector.

24. The high investment grade ratings largely reflect the rating agencies positive view of the sector and specifically the strong regulatory framework and high government support for the credit strength of the sector. Under the new regulatory framework it is important to note that 'economic' regulation will be sustained not least because of its importance to private investors. Investor considerations are also reflected in the proposals for Universal Credit which suggest continuation of a ring fenced housing element of the total benefit package, and acknowledgement of investor concerns about an end to direct payment.

25. This paper explored what was required to maintain the attractiveness of the sector to the Institutional Bond market. There were a number of factors including:-

- Continuing low business risk profile because of the public-policy role of providers, the strong requirement for affordable housing and high demand for housing generally
- The sector must continue to benefit from strong ongoing support through regulatory mandates.
- The regulatory framework has placed an emphasis upon the continuance of strong governance and high levels of administrative capability around portfolio oversight, asset and treasury management, strategic planning and procedures, and good quality technology/systems. This has helped the housing association sector to cope with difficult strategic decisions when required.
- The legal ability of a mortgagee in possession to sell units at market value subject to existing tenancies , providing a further level of credit enhancement.

26. Within this strong business profile, financial sustainability is seen as an important factor in affordable housing credit worthiness. There are a number of factors including;

- Freely available cash, predictable cashflows with limited correlation with economic or investment cycles.
- Financial flexibility – including the ability to raise cash through property disposals of let or void properties.
- Continued low leverage – average leverage for UK associations is 42% (taking grants into account as equity). Given that most RPs hold assets at depreciated historic cost , rather than existing use or market value subject to tenancies, this figure probably overstates the effective level of balance sheet gearing.
- Strong cash flows underpinned by good rent collection records and government housing benefit

27. Going forward, we recognise that the credit ratings of housing associations could be impacted by a combination of:

- Substantial cuts in housing benefits, leading to increased rental income volatility and lower margins. Rule changes may have disproportionate effect on some sectors of the market and RPs concentrated in these areas.
- Changes to the calculation and/or method of payment of Housing Benefit,
- Continued pressure on capital grants, which could steer RPs towards increased debt and high-risk commercial activities
- Increased exposure to the property market as rental levels become correlated with and closer to market levels.
- Potential costs of compliance with the Climate Change agenda.

28. However, though there are some difficult adjustments to make and there will be impacts upon individual associations, our overall view is that the housing association sector is generally well equipped to cope with the new regime, although overall activity levels could be impacted and individual associations will face considerable pressures reflecting the geography of their stock and local market conditions.

29. Indeed it now places a premium on innovation and creativity and the evidence to date suggests a number of associations are beginning to put significantly more effort to thinking outside of the 'grant box'. This will increase their engagement with private sector solutions and in that sense open out more possibilities for engaging with institutional investors. However there may be a risk of a two tier sector - between those developing RPs who are well placed and have signed up to the new affordable deal and others whose activity is likely to be restricted. Focus will also be needed on the effective utilisation of the financial capacity of this latter group.

Alternative Institutional Debt

30. Reflecting the emergence of new appetites from both associations and investors we note a number of developments including;

- M & G Fixed Income is looking to launch a fund to provide limited price indexation (LPI) linked debt to lend to housing associations and thus helping pension funds to match their inflation-linked liabilities. The fund will be marketed to Pension Funds, although M&G life insurance is also a potential investor in this product. Most index linked pensions are subject to a cap on RPI, typically at 5%, and a floor of 0%. Therefore mature pension funds are happy to buy index linked assets with similar floor and cap, known as limited price inflation (LPI). Historically there has been minimal LPI issuance.

- This follows on from the UK Companies Financing Fund, where M & G has raised £1.6bn in commitments from institutional investors, principally also UK pension funds and is looking to become an active sole lender to mid-market UK companies. To date loans have been made to Taylor Wimpey and Eddie Stobart.

- A similar move for the social rented market would involve establishing a 'club' of institutional lenders and then seeking appropriate borrowers from amongst the RP population. This is somewhat akin to the Private Placement market, but reverses the normal process by seeking lenders before or at the same time as borrowers.

Index Linked Debt

31. The pension fund appetite to match assets and liabilities is strong and within that fully index linked debt has considerable appeal. The same is true for life assurance companies looking to fund index linked annuities. In particular there is demand for amortising index linked assets. Traditional Index Linkers differ from conventional bonds in that both the semi-annual coupon payments and the principal payment are adjusted in line with RPI. However there has been limited issuance of index-linked debt by Housing Associations. There were a few issues over 10 years ago, but

appetite was limited reflecting the housing associations experience of this type of debt and permanently rising interest costs were not seen as attractive even though the starting rate might have looked desirable.

32. From a pension fund or life insurance company index linked investments allow matching of assets to their liabilities to pensioners or annuity customers. The indexation regime of both target rents and housing benefit provides an underlying match. Whilst the new affordable regime will have greater linkage to market rental levels, historic correlation of market rents to average earnings has been high.

33. Although there are concerns to be overcome as we discuss later, from a RP viewpoint issuing index linked debt does offer some advantages:

- Reduces the RPs exposure to inflation. Whilst typically inflation has run at a higher level than modelled (providing upside to RPs), the 1.4% deflation in 2009 reminded them of the risk.
- Eases initial interest cashflow burden.
- Allows the relaxation of the initial interest cover restriction, for LSVTs or newly created vehicles which are run on cash rather than accounting ratios.
- Allows the RP to "lock into" a higher inflation rate than the 2.5% traditionally modelled. Current market implied 25 year inflation rates are c 3.5%.

34. The lender is taking more back end risk, but is protected against the impact of a low inflation environment.

35. Recognising the merits of these arguments, this paper proposes a closer examination of using index linked finance, a view recently also espoused by the New Economic Foundation (2010). Traditional RSLs have preferred not to issue index linked debt reflecting a number of factors including:

- A substantial element of existing inflation hedging already exists through the operating cost base. Most expenditure relates ultimately to labour costs, which is inflation correlated through average earnings.
- Concern over basis risk in the event that rpi increases cannot be passed on in rents, either due to regulation or market forces, whereas the RP is obliged to pay inflation on its cost base.
- The increased refinancing risk associated with accreting balloon repayments**,** as the nominal repayment sum increase over time, in contrast with a traditional loan.
- The need to post additional security over time, to maintain asset cover ratios. Where assets are valued on an existing social housing use basis, this risk would be expected to be lower (as the future cashflows will be inflation linked), than where the valuation is more market determined
- Real interest rates have been recently negative over a large part of the yield curve, and as a result in the short term indexed linked debt has been more expensive than conventional debt. Whilst the relationship between real and nominal rates will change over time, negative interest rates are considered unusual outside a period of high inflation. The interest environment has been beneficial to RPs but could easily reverse.
- Under current accounting rules, both the coupon payable and the RPI uplift in the bond are treated as an interest charge taken through the Income & Expenditure Account. Therefore there is little benefit for those RPs whose principal funding constraint is accounting interest cover.
- There is some uncertainty over the impact of IFRS – however it is likely that an I&E charge will remain in respect of the uplift.
- Index linked issues have historically traded at wider spreads than fixed rate issues. Although this may in part be due to duration reasons (index linked credit risk is more back ended), it also reflects a far thinner market both for index linked debt in general and RP indexed linked debt in particular.

36. But we would take the view that these concerns can be mitigated in a number of ways including;

- Use of limited price inflation issuance with a cap of 5% and a floor of 0%. This will provide with protection against abnormally high levels of inflation, when rent restrictions are more likely, albeit with a risk in a deflation scenario. However in a deflation scenario fixed rate debt would be even more problematic.
- For RPs only a percentage of debt would be index linked.
- Use of amortising repayment profiles to smooth refinancing requirements. Alternatively to index interest only and have a bullet repayment of the initial principal, as for a conventional bond.
- With more issuance the pricing differential would be expected to narrow. The coupon divergence in utilities, where there is more index linked issuance, but still a minority, is around 10 basis points.

37. It is possible some of the benefits of index linked issuance can be obtained from an index linked swaps strategy, which can be combined with bank debt, allowing greater financing flexibility. This also permits the ability to overlay an indexation strategy over existing debt, rather than require issuance of new debt for which immediate deployment may not be possible. However there can be issues arising from the need to pledge assets or cash in support of swap exposure and there are uncertainties over the treatment of swaps, and particularly hedge accounting, under IFRS.

38. Clearly, better understanding of the long term rental regime would be advantageous, which in turn is also linked to the regulation regime. This extends to the regime for payment for housing benefit, given that the majority of social tenants receive housing benefit. This certainty would be more important for a project based financing (e.g. a LSVT) looking to raise a high percentage of index linked financing. One option, at least in theory, could be to grandfather rental regime arrangements in respect of certain qualifying assets for a minimum period, although this could result in rental divergence between social provision as a result of ownership. This principle has been implicitly accepted in the affordable rent model.

39. The recent announcements in relation to benefits (and public sector pensions) being indexed by CPI rather than RPI, leads to an expectation that a RP rental regime may be CPI linked though this now seems unlikely in the short term at least . The Affordable Homes Programme Framework, published by DCLG and the HCA on 14 February 2011, confirmed that social rents would continue to be governed by the RPI +0.5% formula for the remainder of the spending review period. Whilst it is likely that markets will develop in both CPI and RPI linked instruments (and possibly LPI in both), most investors are unlikely to have a perfect hedge anyway. Due to the method of calculation CPI will tend to run c 50 bp below RPI, assuming that the relative baskets perform identically. Over 30 years investors are likely to anticipate that short term differences in CPI and RPI will largely even out, leaving the core 50 bp difference which can be factored into cashflows (or alternatively the real growth rate adjusted to reflect).

40. Further consideration should be given to the use of index linked debt albeit with appropriate safeguards. We would see this as a step towards securing wider institutional involvement in this market.

Project Specific Debt

41. With reduced grant funding and limits on the scale of rental income, registered providers will face borrowing capacity constraints – particularly, as indicated above, against gearing covenants. The Group felt it was important to note the potential of an alternative to recourse debt, which is project specific financing or debt provided to social housing investing entities where majority ownership of the entity is not with a housing association.

42. If the restructuring of the Housing Revenue Account regime progresses as envisaged, local authorities will have greater flexibility with regard to their management of housing, but will be subject to aggregate borrowing constraints. This could lead to an increase in large scale voluntary transfers of housing stock (LSVTs) and tenant management (TMO) type initiatives, potentially involving the creation of new borrowing entities.

43. In addition, where the funding is project specific (rather than to a registered provider's corporate covenant) an investor would need to be comfortable that the operating risk has either been laid off (as, for example, under PFI), covered by adequate contingency or the potential value of reversion to open market value in distress situations. Housing Associations and/or other entities would enter into leases or contracts for maintenance, letting and management services.

44. We are likely to see RPs entering into joint venture arrangements with developers or investors, and whilst, traditionally, limited recourse development finance has been provided in by banks in highly structured facilities, there is no reason, particularly post practical completion of the 'development', why such finance should not be provided by institutions.

Equity Investment; Institutional ownership of residential property

45. Institutions have traditionally been major investors in UK commercial property with an estimated £250bn institutional investment market. The low share of residential (0.3%) in the index compared with other European markets has been the subject of much debate. Traditionally most institutional property investment has been "core", and concentrated on the office retail and industrial properties let on fully repairing and insuring leases. Long term target returns are typically 2- 3% over gilt - say 7-8%.

46. Recently two important trends have become evident. First, a willingness to invest in less traditional asset classes such as student accommodation and hotels. Second, a focus on secure property income funds, focussing on long leased properties, preferably with rpi linked leases as liability matching assets. In contrast to traditional return seeking property funds, where an exit within 10 years is typically required, liability matching assets are considered more likely to be held until maturity.

47. Since the prime attraction is certainty and predictability of cashflow, investors in liability matching assets are risk adverse in terms of operating and tenant credit risk, with a requirement for investment grade tenants.

48. The large UK investors have set up specialist teams to target this market and effectively arbitrage between the property and bond markets. This has been seen in the demand for supermarket RPI linked sale and leasebacks with yields driven down to initial yield of c.4.5%. These assets are attractive because of their limited exposure to the property market (other than residual value on lease expiry).

49. Secured property income funds, are currently targeting minimum net returns of c 3%-4% real (i.e. above inflation), compared with the minimum 5% real typically required by core commercial property investors, or the 5-7% real targeted by residential investors. The target return for secured property investors corresponds to sale and leaseback deals for properties with rpi linked leases at an initial yield of say 4.5%.

50. Social housing has low correlation with economic cycles, the performance of other investment markets and has natural inflation linkage. It should therefore be attractive for liability matching purposes. There are also potential benefits for investors looking for investments with social responsibility characteristics. There had been some very limited investment in properties leased to RPs in the past, but these were held by the more traditional property teams.

51. To meet the requirements of this investor base, and provide greatest comparability with the alternative options, a structure in which an RP took an overriding FRI lease underwriting both agreed occupancy levels and operating costs would be the simplest route.

52. Given the current RPI plus 0.5% rental regime and the lower obsolescence associated with social housing, a lower initial yield should be justifiable, compared with commercial property, Whilst the effective cost of funding would be expected to be more expensive than RP full recourse debt, particularly if applied to new build this structure could extend the supply of housing.

53. Given the limited investor focus on the residual value of the property at the end of the initial term, longer term RP time horizons and the benefit of management alignment structures which provided the RP with a share of the residual value would seem to offer better economic value.

54. The investors security of cashflow and/or return could be enhanced by inclusion of the ability to sell voids in the open market, and/or mortgagee style market value sale rights exercisable only a default situation, both to enhance values and improve liquidity.

55. There are similar models being considered in relation to open market rental, or mixed intermediate/open market, where the RP will take an overriding lease, as a result of which the investor will require a lower return than would apply for full open market risk. This is particularly true for geographic areas less in favour with potential institutional PRS investors, where there is likely to be limited market knowledge and demand. In contrast the RP would have a good local knowledge, albeit recognising its risk position under the lease. Setting the lease at below current market rental levels would provide some comfort,

56. In our view there is an obvious synergy between Local Authority Pension Funds and social housing in the local area, as institutional investors with a liability matching requirement with the additional benefit of contributing to their local area. In addition, mirroring a number of initiatives being used by major companies (such as M & S with stores or Carillion with PFI assets) Local authorities could transfer housing stock either as in kind contributions to their pension funds or use as contingent assets.

57. There are a number of issues to consider including;

- Scale – probably £50- £100m for a major investor to make the due diligence on the market worthwhile.
- To achieve diversification of operator and geography, access for smaller funds, secondary liquidity and a buffer between the assets and the institutions we would expect some investors to have a preference for investing indirectly through asset owning special purpose vehicles.
- An investor would need to be comfortable regarding the risk regime change in respect of rents and/or Housing Benefit levels. The recent changes to Housing Benefit linking it more closely to dwelling size/occupancy in the social sector are significant here.
- There is a question as to whether, under certain structures the landlord fund would need to be registered, although since the tenant interface would be expected to be via an RP, this is considered less likely.
- The extent that RPs are assuming liabilities under lease or management arrangements, will affect their corporate risk profile. The impact will depend on the nature of the obligations and underlying volatility of the markets, but the regulator would be expected to monitor liabilities.

58. Over time, as investors obtained greater knowledge of and comfort with the underlying social housing market, we would anticipate greater appetite for risk sharing both of income and operating risk, without the cost of funding increasing to

levels associated with property market risk. There is a precedent in the student accommodation market which started on the basis of nomination rights and/or leases, where over time investors have become more comfortable with demand and operating risk. Student accommodation is now recognised as an asset class in its own right with private sector investors estimated to own £7.5bn of the £20bn purpose built student market, including university owned accommodation.

Equity Investment in affordable housing

59. There has been considerable debate about the potential for equity investment in affordable housing although there are a number of difficulties to overcome including how such a model fits with non profit RPs, how investors achieve a secure return and the blurring of the boundaries between public and private sectors. The recent Policy Exchange report (2010) has argued for a new social enterprise model in which loan debt is exchanged for equity. The report suggests that there is a net asset value of around £128 billion and that £30 billion of new financing might be available to fund around 300,000 new homes though critics have suggested that since this figure is based on pre-interest cashflow the net benefit would be more limited. The report acknowledges that what happens to the current imbedded grant has to be resolved.

60. The EC Harris report (2010) argues that we need to unlock the latent value of housing and local authority stock. Through a range of measures it is argued £125 billion could be released for re-investment by a mixture of sales to 'for profit providers' along with efficiency savings of around 30% which would also increase the debt service capacity. Again it is recognised that there are a number of risks that must be guarded against and that further legislation may be required. The sale of income producing property will lower the debt raising capacity of the RP. So unless the sales are for non social use (or for higher rental levels), or are at an initial yield lower than the cost of finance, the benefit may be limited for those RPs who do not have balance sheet gearing constraints.

61. The Group explored a number of different dimensions regarding equity investment. Including whether institutions might enter this market but also a range of other possible models.

Institutional Equity investment in RPs

62. Equity from institutions could be invested into newly created RPs or existing Housing Associations. However this does raise a number of issues, including;

- Legislative – is it allowed? Developments in the building society sector are relevant here where these other types of mutual entities have created instruments which allow equity injections to take place – permanent interest bearing shares (PIBS) being converted into profit participating deferred shares (PPDS) and most recently the creation of a banking subsidiary which is held as a joint venture with the equity provider.
- Running Yield issues – net initial yields on new build have been insufficient, without grant, to attract institutional interest though returns could be boosted by open market rental or sale and the new regime announced by government does shift potential returns upwards. There will be a benefit if investors are happy to receive a total return, rather than initial yield, which can be serviced from surplus cashflows in the future. This is a similar argument as that relating to an index linked approach discussed above.
- If housing association debt was re-financed with investors buying in with an equity stake on appropriate terms there might be two benefits. Firstly it should give associations a real capacity to develop outside of the grant based regime. Secondly with new partners and business models there would be a significant culture change which should lead to greater efficiencies, both in terms of operating costs and use of asset base.

- Efficient financing theory would suggest that equity returns should not be funded by cashflow which could otherwise be comfortably used to service senior debt (which will represent a lower cost of capital). In this regard RPs may be happy to consider a reduction in credit rating, within acceptable parameters, to support further development. Equity would enable an RP to run a higher level of debt whilst maintaining its minimum target credit rating, with the equity providing a buffer against cashflow risks.
- The additional cashflows available to service equity returns could be expected to accrue from incremental sources of income:

  - Proceeds of asset disposals from efficiency based rationalisation of portfolios (with sale to other HAs as social housing) and/or selective sale of void assets on the open market.
  - The impact of the new affordable rent regime as units become vacant and are relet under the new regime.
  - Future projected cashflow increases from rental growth, new developments or other initiatives and / or ability to refinance against these cashflows in future.
  - Efficiency gains in operating costs, either at the individual RP level or via inter RP collaboration.
  - Alternative income streams (such as market based activities or housing management), but recognising the change in risk profile if the RP is absorbing risk.
  - Assessment of the benefits of rationalisation on merger of RPs

63. To be effective equity cannot be categorised as debt under the RP's gearing covenants or by the rating agencies. Since grant is legally unsecured debt in a winding up, any preferred equity proposals are likely to request some form of effective subordination of grant, in order to produce a balance sheet more acceptable to investors. One option could be to reclassify as equity with grant retaining rights to participate which would be triggered for example in the event of major asset sales, distributions above a threshold being made to investors or change of purpose etc. It is only envisaged that grant conversion would take place as part of a wider initiative and would not result in governmental control of the RP concerned.

64. Governance arrangements will need to balance the proportionality of the investor's investment (and influence) with the existing business, (and the historic asset base), whilst obtaining the benefit of external commercial input. Structures which envisage investment only in non regulated activities would be more transparent in this regard, although that would typically entail a market cost of capital, appropriate to the activity being financed. We should note however that where an investor is receiving an equity return their capital needs to be at risk. In the same manner that living wills are being discussed in relationship to banks, a similar concept may be needed if the regulator was required to take action in respect of a RP.

Other Potential Equity Structures

65. This paper considered a number of other routes through which equity might be introduced**.** These included grant capitalisation, setting up Housing Association Profit Participating Deferred shares and the creation of for profit providers.

Grant Capitalisation

66. Government converts its grant to equity, or sets up a non-public sector investment company – and sells its shares to investors to raise cash which can then be used as government chooses although unless it is re-applied to the sector in full or part there is no net gain to the sector. Grant currently carries no coupon and is only redeemable in certain events which are outwith grant providers control. Its conventional commercial value therefore is limited. To give attraction to the private sector

additional return will be needed to service the equity, so, there will be a net drain on cashflow at the RP Level, unless associated with some wider asset management or other initiative. In short grant capitalisation alone is unlikely to improve RP finances, but could be a part of a wider business plan.

HAs Profit Participating Deferred Shares (PPDS)

67. As mentioned above these are in use by a number of building societies to replace Permanent Interest Bearing Shares (PIBS) which are no longer deemed adequate because not full risk sharing/loss bearing equity. PPDS have been issued by the West Bromwich BS to replace their PIBS but the alternative for the investors in this case was liquidation of the society. It is not clear yet if PPDS can be anything other than long stop 'in extremis' equity finance. Most recently discussion in the Building Societies Association has turned to PLADS, permanent loss absorbing deferred shares though again it is not clear who the buyers would be. All of these more recent structures are to deal with existing investors and how to carry them forward in the event of losses. It is far from clear that there is anything yet which might be of use to housing associations in terms of a vehicle through which investor appetite could be channelled.

Social Housing Trust (SHT)

68. Setting up a Social Housing Trust is a potential outcome of changes to HRA and an alternative to LSVT for Local Authority stock. It provides for a pooled project based funding structure for Local Authorities, with an umbrella not for profit holding entity and sub funds for separate authorities. Existing assets would be transferred to the entity to create gearing capacity to be reinvested in new stock and the upgrade of existing homes. LAs could retain subordinated debt, which would correspond to the residual interest in the properties and cashflows. This could be deferred to assist reinvestment, in a similar concept to the RCGF.

69. Tenant management would be undertaken by RPs or Almos, probably under lease arrangements, with maintenance either undertaken by the same entities or procured on a Fund basis. Economies of scale could give advantages over smaller LSVTs or stand alone entities in both operating and financing cost.

70. Other models might include the Welsh Housing Investment Trust which aims to raise capital in a joint venture between government and the private sector to support social housing development in Wales (Scotland is considering an equivalent).

Private RPs

71. Regulated' with Profit RPs are now allowed but there has been little interest to date. There are however precedents with Social Housing PFI, where private sector contractors provide the management services typically provided by the RP sector. There is a with profit version of the Social Housing Trust model under consideration. Paradoxically despite potential economic benefits of outsourcing, to obtain economies of scale or specialism, the VAT regime discourages outsourcing contracts adding an effective 20% to any costs paid under a management contract rather than performed in house,.

Asset Level RPs

72. For large strategic sites consideration has been given to creation of private RPs to manage social housing on that site and/or for other schemes of the same developer. The benefit would be economies of scale and consistency of management across social, private rental, communal facilities and public realm. A similar model can be applied on an individual block basis (or portfolio owned by the same developer) and a number of parties are considering models which include a mixture of private and intermediate rent under common management. Whilst the new affordable rent regime

is initially targeted at developing RPs we would expect planning authorities to be approached by developers to approve grant free self delivered intermediate rent for S 106 purposes.

The Dutch Model

73. The Netherlands has been through a similar process of moving from a grant based regime to a privately funded regime. There was a one off write off of grant by Central Government – with RPs becoming financially self sufficient thereafter using their cashflows and assets to raise finance (albeit the Dutch government is guarantor of last resort of loans to Dutch RPs). Results have been mixed with recent criticisms about lack of activity. In the UK context as discussed above write off of grant would not have an immediate cashflow impact, but could assist equity raising**.**

74. A modified Dutch model may have more effect with the conversion of existing grant into shares which are transferred to a non governmental not for profit entity with the explicit mandate to maximise the use of the sector's financial assets in furtherance of social housing provision, with powers connected with this equity. For example this new shareholder could facilitate mergers between RPs.

Institutional appetite

75. One measure of the task before us is to reflect that attracting institutional investment (particularly equity) into the private rental market has not been easy as is evident from successive initiatives by the government. If we are to look for institutional investment in affordable housing it is important to remember what institutions might expect.

76. The evidence from the range of initiatives in respect of the private rental sector would suggest that in that market institutions require a number of core requirements to be met including;

- Total Return requirements are in the region of 8-10%. Gearing is likely to be no more than 30%, but funds may be ungeared. This compares with say 7-8% net for commercial property investment, or 2-3% over an estimate of long term gilt rates of say 5%. We note that the residential investment market has out performed both other property classes and most investment media over the last 10 years as evidenced by IPD.
- For the more traditional UK investors the net rental return is likely to be no more than 4% net yield with the balance capital growth. To achieve a distribution yield of at least 4% after fees required ongoing unit sales. There is an expectation that required rates of return will reduce down to commercial property levels, with the initial premium due both to a new asset class and the lower initial yield than commercial property.
- A more US style of investors are looking at a higher rental yield model, with focus on new build, with say 5-6% initial and a total geared return of 10% or above, with a more hotel management model and using the student housing sector as template.
- The model typically provides for the ability for the investors to wind up the fund after say 10 years with sale of the units either to another investor or to owner occupiers. The investment is seen therefore as a return seeking investment similar to commercial property (or alternative investments) rather than providing specific liability matching characteristics. This is likely to remain the case whilst capital growth remains a major element of the expected return, portfolios are valued with reference to their vacant possession market value, and volatility expectations remain in capital price movements.

77. These are important issues to consider. Clearly affordable housing has some lower risk characteristics which may ease the requirements but much turns on the scale of the market, familiarity with the assets and organisations and overall liquidity. A recent

CBRE survey (CBRE, 2011) highlights the clear appetite for residential investment with over £7.5 billion currently allocated for residential development or investment.

Equity in Shared Ownership

78. Dedicated Investment Companies which seek institutional finance and bank debt to invest in Shared or Joint ownership are being developed. Asset Trust, a private investment company announced it was in discussion with 10 housing associations to acquire 10,000 shared ownership units backed by an institutional investor to the tune of up to £780m. The aim is to release the capital uplift and grant tied up in the property thus releasing cash for new development.

79. Shared ownership was traditionally targeted at those in work, but whose earnings expectations would not support the mortgage required for full ownership. Since the inability to fund a deposit, rather than servicing a mortgage, has become the key constraint for many, there is increased focus on open market (i.e. unsubsidised) shared ownership models

80. The Mill Group is offering a co-ownership Open market model. The occupier will pay a mortgage related payment on the portion owned and an open market rent on the interest retained by the investor, and in common with other shared ownership schemes, be responsible for maintenance. First Base, a property investment company announced a residential development venture backed by RPS Capital Partners and Elliot Advisors, a US Hedge fund with the intention of creating a residential development portfolio with a value of around £250m.

81. There would seem at present to be a number of constraints on the funding of some types of shared ownership initiatives. These include;

- Shared Ownership financing – The key issue is the level of sensitivity to staircasing assumptions which determines timing of cashflow and return. Open market schemes are able to charge a market rent which helps reduce the sensitivity to timing. Such uncertainty increases required investor return and increases the buyer/seller divergence of view on the appropriate discount. We understand the Asset Trust model requires RP's to guarantee a minimum level of annual staircasing to mitigate this risk.
- Lack of liquidity of the asset as lending security if the co-owner is not in default
- Residual SO units are used by RPs as security with the rental income being included in the interest cover calculation. Therefore the benefit of any sale relates principally to the element of eventual staircasing which can be accelerated.

82. One option could be for Housing Associations to pool their shared ownership loans and raise debt against the pool, whilst retaining the majority of the residual risk/reward on staircasing. Although RPs would pool their SO assets, the originating RP would remain responsible for managing defaults. Proceeds from any debt financing (and subsequent equity distribution) would be subject to the same Recycled Capital Grant rules as current Shared Ownership.

83. There is a substantial amount of historic HCA grant which underpins Shared Ownership. Annually some of this is redeemed as borrowers sell up and move on. Housing associations hold that receipt as part of their recycled capital grant fund. Since the HCA has no control over the rate of staircasing and whether the RP looks to recycle the proceeds, the loans are not held as assets on HCAs balance sheet and are not likely to be financeable or tradeable. Moreover this 'value' is already realised in part through use as security by RPs to underpin existing borrowing. It would be helpful to conduct an exercise where the resultant availability of RGCF was fully explored.

Shared Equity

84. Although considerably smaller in size than Shared Ownership, shared equity has had an influence on the First Time Buyer market in recent years.

85. Shared equity schemes were originally targeted at those with affordability constraints, but with an expectation of redemption within a 10 year timescale, as earnings increased. However in recent years they have helped maintain FTB sales volumes in a mortgage market in which borrowers have limited access to high ltv products. They have been provided either alongside HCA (via Homebuy Direct "HBD") or by the housebuilders individually. Typically a housebuilder only scheme has no running return, but a 10 year sunset date at which the equity loan should be repaid or become coupon bearing, if the occupier is unable to repay. HBD has a coupon after 5 years but a sunset date of 25 years.

86. The HCA is the largest holder of shared equity with c £230m face value under the First Time Buyers Initiative and an anticipated £215m under HBD, when fully drawn. The major housebuilders accounts would appear to show shared equity valued at Persimmon (£115m), Barratt (£136m), Bovis (£31m), Crest (£15m). Housebuilders typically write down HBD immediately to 50% in their accounts and there is thought to have been little trading, at this or any other level.

87. Despite the £210m FirstBuy shared equity programme, announced in the 2011 Budget, given the limited availability of higher LTV mortgages, it is likely that housebuilders will wish to continue to offer some form of shared equity product, as well as be in a position to realise their existing holdings over time. This would suggest encouragement of a secondary market which could extend to offering shared equity or shared ownership on new projects (or structures with the same intention).

88. Increased standardisation between the housebuilder product offer, data capture, seasoning of the equity loans and the pooling of assets could encourage a potential investor base. There is also historical precedent in the UK and Australia for shared appreciation mortgages, which have a similar risk/return profile.

Conclusions

89. Institutions are already investing in affordable housing through the funding of social housing debt as this paper has shown. However the funding requirement is increasing and there is a substantial appetite to explore new structures and methods of financing.

90. As this paper indicates there is substantial potential for the development of institutional finance in the affordable housing sector and there are a number of conceivable models to be applied. Indeed there is now significant activity around developing innovative financing structures and clearly discussions are taking place. A number of structures have been mooted and explored and our hope is that these may soon crystallise into clear commitments, especially around equity investment in RPs.

91. On the basis of current evidence it would seem we are likely in the short term to see developments around exploiting the current asset base and financial strength of housing associations (see for example CIH/Savills, 2011). This is very welcome but we remain of the view that engagement with pension funds and other institutions is vital in the medium to long term not least because that housing association asset base and financial strength has to continually grow.

92. This paper proposes a number of key steps that now need to be taken to give added momentum to the work already underway. These are;

    - Set up a structure for bringing the social housing sector and institutions together to engage in a sustained dialogue. This can build onto the existing presentations to institutional debt investors with the aim of improving understanding of the sector.
    - Preparation of a prospectus on the strengths and capacity of the affordable housing sector and the potential returns to institutions. This will require detailed work on yields and returns under the new rent regime.
    - Specifically engage with local authority pension funds.
    - Undertake a specific study of how current shared ownership/equity assets might be monetised.
    - Undertake a detailed study of the costs and benefits of index linked financing for RPs.
    - Take forward the exploration on equity investment in RPs. In particular the possibility of reclassification of existing social housing grant to facilitate equity investment and suitable governance structures could be explored.

93. The discussions highlighted in this paper have shown there is considerable potential for development. In the past it has been possible to see this as an ‘add on’ to a well-developed grant regime. Going forward this is less likely to be the case and it is important we now move forward to find and develop a new base structure for the funding and development of affordable housing in the UK. In our view there is clear synergy between the needs of this sector and the institutions, and it would be worthwhile if both parties commit time and resources to the process. We recognise the pressures on institutions in terms of the need to manage their assets and liabilities in a time of great uncertainty. In our view investment in the affordable housing sector would in fact give significant long term comfort to fund managers.

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